ACREL News & Notes
March 2019

Ground Rent Disasters and Some Possible Ways to Prevent Them

Joshua Stein, *Joshua Stein PLLC*, New York. NY

Tenants under long-term ground leases have recently suffered huge losses because of ordinary and traditional rent reset formulas that adjusted the ground rent to equal the current value of the leased land, considered as if vacant, multiplied by a constant such as 6% or 7%. That type of formula made sense when commercial real estate capitalization rates, an important element in determining land value, were not as low as they are today.

In today's market, though, especially in major cities like Washington and New York, commercial real estate values take into account capitalization rates far below 6% or 7%. So when the rent adjusts based on a 6% or 7% rent constant applied to a land value reflecting a much lower cap rate for commercial real estate, tenants can face a rent adjustment that eats up their entire net operating income.

There's got to be a better way. It is a conversation I have regularly in the course of deals and in response to inquiries from other lawyers all over the country. Here are a few of the ideas we kick around.

Maybe we can cap the land value rent reset, for example at a cumulative compounded increase of 3.5% per annum since the commencement date or the last land value rent reset. Over an extended period, 3.5% has been a reasonable upper bound for average annual real estate appreciation in the United States, even in Manhattan, so perhaps we should hard-wire it into the rent adjustment. Some leases now do that. Many landlords would reject the concept, though, because it doesn't protect them from hyperinflation.

As another option, maybe rent should increase on each periodic adjustment date based on the consumer price index, or some percentage of it. Over an extended period, that measure too has rarely exceeded an average increase of 3.5% per year. But it has no necessary relation to real estate values or to the value of the particular leased real estate. Still, it protects the tenant from increases that exceed general inflation rates.

Sometimes tenants offer to pay participation rent – a small percentage of the tenant's gross revenue or a larger percentage of the tenant's net revenue – as a substitute for any form of periodic rent adjustments. That type of rent exposes the landlord to risks very inconsistent with the passive coupon-clipping investment that a ground lease is supposed to create. It also does not create a stable stream of ground rent that can support maximum financing of the landlord's estate. What if the tenant mismanages the property? What if the tenant enters into transactions to reduce the tenant's income at this location in exchange for goodies somewhere else? What can the tenant deduct and what opportunities does that create for the tenant? This rent structure is difficult but not impossible, especially if it uses a "gross" measure of income and keeps things simple. It sometimes appears in ground leases.

If the landlord doesn't want to get involved in the actual financial results of the building, how about letting the landlord participate in the hypothetical financial results the building "should have" achieved from time to time, taking into account current market conditions? So instead of giving the landlord a piece of actual gross revenue or net operating income, the tenant would pay contingent rent based on the financial performance of a basket of similar buildings, either gross or net. If the building is a hotel, maybe the rent would equal some function of RevPAR of the competitive set. For an office or multifamily building, rent might depend on current market rents for new leases in the market as a whole, or at least the market stratum in which this building competes, assuming some reliable market index exists.

As another option, why not re-size any adjusted rent so it gives the landlord a rental stream that equals the current market value of the landlord's land as if the lease did not exist? The lease could include some guidance on how to do that, but mostly leave it to the appraisers. If land values bake in low capitalization rates at the time of adjustment, then the landlord's annual return on the land value, via rent, would reflect a similarly low rate. To my knowledge, no one has ever tried this formula.

I regularly see ground leases with a completely pre-established rent schedule for the entire term of the lease. Each year's rent can be determined by looking at an exhibit. Lenders and tenants love this rent structure. Landlords can tolerate it by applying a high enough discount rate to the stream of cash, sufficient to compensate for the risk of future hyperinflation.

The issue of future rent adjustments over the very long term of a ground lease represents the single most important issue that landlord and tenant, and their counsel, need to negotiate. And once they accomplish that negotiation, counsel needs to assure the ground lease properly reflects what the parties agree.[1]

4852-6622-0166, v. 16

[1] Given the importance of this issue, I've written a few articles about it and will focus on it again as part of my upcoming book on ground leases. That book should come out in 2019 or 2020, a complete rewrite of my ground lease book that ALI-ABA (now ALI-CLE) published about 15 years ago. This time I'll publish it myself, with no third-party publisher. I've been working on it for about a year. Until the new book appears, I'm happy to share parts of my manuscript, including model documents, with anyone who promises to review carefully whatever I send them, and submit comments in a reasonable time. If that sounds tempting, or if you would just like to know when the book will become available, please send email to office@joshuastein.com.