

# Ground Leases and Value-Based Rent Resets: An Alternate Reality

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In New York, many long-term ground leases include provisions requiring the periodic resetting of rent based upon the “fair market value” of the land subject to the lease. These rent reset provisions often give rise to arbitration or litigation, and the stakes can be enormous for landlords and tenants alike. New York courts have developed a distinct set of rules that govern the determination of fair market value in these types of rent reset cases. Litigators involved in rent reset cases are well-advised to carefully consider how lease restrictions, zoning restrictions, regulatory restrictions and the remaining term of a ground lease may affect the fair market value of land subject to a lease.

## Use Restrictions in the Lease

New York courts have long held that in a value-based rent reset, “absent an agreement to the contrary, the effect of a net lease must be considered in valuing property for the purpose of setting rent for a renewal lease term.”<sup>1</sup> Despite its simplicity, this rule can result in an appraised “fair market value” that vastly differs from the actual economic value of the land to either the landlord or tenant.

Two early cases involving parcels along Third Avenue in Manhattan illustrate the divergent outcomes that can result from variations in lease language. The first case, *Ruth v. S.Z.B.*, from 1956, involved a parcel of land at 61st Street and Third Avenue in Manhattan that was improved by a retail building and several brownstones.<sup>2</sup> Under the terms of the ground lease, the lessee was obligated to maintain the existing buildings and forbidden from making alterations to the buildings.<sup>3</sup> During the term of the lease, elevated train tracks along Third Avenue were demolished, making the subject land more attractive and valuable for uses other than those permitted by the lease. The ground lease, however, provided that for purposes of resetting the ground rent, the land was to be valued as if it were sold “vacant and unimproved, in fee simple, by private contract, free of lease and unencumbered.”<sup>4</sup>

In a declaratory judgment action brought by the lessor seeking an increase in rent, the defendant lessee argued that the limitations contained in the lease (which prohibited alterations to the existing buildings) had to be considered in determining fair market value. The lessor argued that because the lease itself stated that the land was to be valued “free of the lease,” the use restrictions should be ignored. The court sided with the lessor and held that the use restrictions in the lease had to be ignored for purposes of valuation. While acknowledging that valuing the land without considering the use restrictions in the ground lease might seem inequitable to the lessee who was contractually prohibited from making alterations necessary to realize the full value of the land, the court found nevertheless that “[i]t would be repugnant to the language employed to hold that the limitation on use springing exclusively from the lease itself may be treated by the arbitrators as an element of value. Whatever else the parties may have had in mind, it is inconceivable that when they declared explicitly that the land be valued ‘free of the lease’, they intended that the arbitrators might give heed to the very lease which so declared.”<sup>5</sup>

The second case, *United Equities v. Mardordic Realty*, from 1959, involved a parcel of land at 64th Street and Third Avenue in Manhattan that was improved with a garage.<sup>6</sup> As in *Ruth*, changes in the neighborhood during the term of the lease made the land more valuable as an office or apartment building than as a garage. Unlike in *Ruth*, the contracting parties had not expressly excluded the lease from consideration in fixing the land value, stating simply that the parties were to establish the “fair market value of the land covered by the first renewal lease.”<sup>7</sup> Confronted with such language, the court departed from *Ruth* and ruled that the lease must be considered in establishing land value: “There is no language in the lease or modification thereof which excludes them in the determination of the fair market value of the land. The fair market value of the land is therefore to be determined by reference to the terms of and the renewal options contained in the lease and modification thereof, and, in addition, the restrictions, if any, therein affecting the land.”<sup>8</sup> Thus, whereas in *Ruth*, because the valuation clause included the terms “free of the lease,” the land was valued as fee simple property available for any legally permissible use, in *United Equities*, because such terms were not included, the land was valued as leased property, subject to any use restrictions in the lease.<sup>9</sup>

The holdings in *Ruth* and *United Equities* have been reinforced numerous times over the ensuing decades, perhaps

most famously in the 1967 case *Plaza Hotel Assocs. v. Wellington Assocs.*, which involved the land beneath the Plaza Hotel.<sup>10</sup> The lease called for a determination of the value of “the land only, exclusive of the buildings and improvements thereon,” and the parties’ appraisers concluded that the land would be more valuable if it were used for an office building rather than a hotel.<sup>11</sup> The lessee objected to the appraisals, arguing that the lease restricted the lessee to the less-valuable hotel use and because the lease’s valuation provision failed to exclude the lease itself as an encumbrance, the appraisers were required to value the land as if it were available only for hotel use. The courts agreed, finding that there was no suggestion in the valuation clause that “the restrictions to hotel use imposed by the lease were to be disregarded and the land valued as if it were vacant and available for the highest and best use.”<sup>12</sup> The court directed the appraisers to produce new appraisals, valuing the land subject to the lease, resulting in a lower ground rent than the lessor could have otherwise obtained for the land on the open market.

The early triumvirate of cases, *Ruth*, *United Equities*, and *Plaza Hotel*, retain their vitality today and are routinely cited for the principle that under New York law, “valuations of land must take into consideration all encumbrances thereon, including restrictions as to its use, unless there is a clear provision to the contrary.”<sup>13</sup> Litigators involved in a rent reset litigation must carefully consider any lease restrictions and analyze the rent reset provisions of the lease to determine whether these restrictions should be taken into account in determining the fair market value of the land.

## Zoning Restrictions

Like the lease-based use restrictions discussed above, zoning regulations can also affect the outcome of a value-based rent reset, as demonstrated by *New York Overnight Partners v. Gordon*, which involved the land under the Ritz-Carlton Hotel on Central Park South.<sup>14</sup> Under the lease, rent was to be determined by the “appraised value of the land,” which was defined to exclude “the buildings and improvements thereon.”<sup>15</sup> At the time of the re-appraisal in 1993, then-existing zoning regulations permitted the construction of a new building of approximately 82,500 sq. feet, substantially less than the existing structure of approximately 152,000 sq. feet. The lessor argued that because the lessee was legally entitled to the continued use of the larger building, the appraisers should be directed to consider the benefit imparted to the land by the legal but nonconforming use enjoyed by the lessee. But the courts rejected the lessor’s argument. The Appellate Division, First Department, later affirmed unanimously by the Court of Appeals, concluded that “the Lease requires the appraiser to determine the value of the raw land, not the property, hence the value of the land must be determined as though it were vacant, without improvements, and subject to current zoning restrictions and contractual limitations as well as the effect of the Lease itself on the value of the land.”<sup>16</sup> As a result, the fair market value was based on a hypothetical 82,500 sq. foot building, even though the lessee enjoyed the use of a 152,000 sq. foot building on the property.

The lessee enjoyed a similar benefit in *Manhattan Church of Christ v. 40 East 80 Apt.*, despite different lease language than in *New York Overnight Partners*.<sup>17</sup> In *Manhattan Church*, the lessee leased property for the construction of an apartment building. Under the ground lease, the lessee was also granted the lessor’s right to certain development rights, which permitted the lessee to construct an apartment building that was larger than the lessee could have otherwise constructed on the leased land under applicable zoning regulations. When it came time to establish a new ground rent, the lessee contended that these additional development rights should not be considered by the appraisers because the lease stated that the land was to be valued “as vacant, unimproved and unaffected by this lease.”<sup>18</sup> The courts agreed with the lessee:

The fact that plaintiff actually gave the lessee its air rights in section 9.3 of the lease does not help plaintiff, since section 21.1 (governing valuation of the demised premises) says that the land must be considered as “unaffected by this lease.”<sup>19</sup>

## Regulatory Restrictions

Regulatory restrictions can also affect valuation and must be carefully considered. For example, in *853 Seventh Ave. Owners v. W&HM Realty*, the lease required the appraisers to value the land “exclusive of any buildings or improvements thereon.”<sup>20</sup> The court held that because the lease mandated the valuation of the land only, the appraisers were to disregard the fact that the existing building was subject to rent stabilization and rent control laws, and thus of lower value. In response to the lessee’s contention that “it will be unable to run the building at a profit if the rent fixed by the appraisers ignores the rent stabilization and rent control laws,” the court stated “economic hardship is not a reason to rewrite a lease made between two sophisticated commercial entities.”<sup>21</sup> Similarly, in *Archdiocese of New York v. Amedeo Hotels Ltd. P’ship*, the court held that because the lease required that the land be valued “as vacant, unimproved and unencumbered by this lease,” the appraisers were prohibited from considering the existing building’s landmark status because such status was “inextricable from the existence of the buildings.”<sup>22</sup>

Regulatory restrictions can also affect valuation indirectly. For example, under New York’s Condominium Act, residential condominiums can be constructed only on land “owned in fee simple absolute.”<sup>23</sup> As a result, if the valuation clause of a ground lease requires the land to be valued subject to the lease, the appraisers would be barred from valuing the land as available for condominium use. Such a restriction can have a significant effect on valuation given recent market trends in

Manhattan that make condominium development an attractive, and often lucrative, land use.

## Time Restrictions

Perhaps the most complicated question that can arise in a value-based rent reset is what consideration, if any, should be given to the unexpired term of the lease when appraising fair market value. This question arises whenever land is to be valued subject to the lease because appraisers must consider financial feasibility as part of their analysis of a site's highest and best use.<sup>24</sup> If the remaining lease term is not long enough to amortize the cost of a given improvement—for example, a 40-story office building—then that use must be excluded from the appraiser's analysis, with the incongruous result that the hypothetical value of the demised land could *fall* as the ground lease approaches termination because only small buildings would be financially feasible to construct on the site.<sup>25</sup>

Furthermore, valuing land subject to the remaining lease term poses a methodological challenge for the appraiser because the amount of the ground rent drives the valuation, which in turn drives the amount of the ground rent. Judge Charles D. Breitell picked up on this issue in his dissent in *United Equities*, writing that "in determining the land value, to look to the lease term, even as only one of several factors, may involve an appraiser in an inescapable circle of reasoning."<sup>26</sup> Although one of the authors here was involved in a ground-rent arbitration that presented precisely this issue, the authors are unaware of any reported decisions in which an unexpired lease term was actually considered.

## Conclusion

As illustrated by the cases above, a variety of factors can affect the valuation of land, making it difficult to predict how the language of a ground lease will affect the parties' bargain in future decades. Today's highest and best use may be rendered suboptimal in future years by local market changes and demographic trends. Likewise, changes to zoning or municipal laws can render a given parcel of land more or less valuable over time. A litigator involved in a rent reset dispute must carefully analyze the lease and the various restrictions placed upon the use of the land to determine how these factors may affect the value of the land in dispute.



1. 936 Second Ave. v. Second Corporate Dev., 10 N.Y.3d 628, 633 (2008).

2. 2 Misc.2d 631 (Sup. Ct. N.Y. Cnty.), aff'd 2 A.D.2d 970 (1st Dep't 1956).

3. *Ruth*, 2 Misc.2d at 634.

4. *Id.*

5. *Id.* at 636.

6. 8 A.D.2d 398 (1st Dep't 1959), aff'd 7 N.Y.2d 911 (1960).

7. *Id.* at 399.

8. *Id.* at 400.

9. Although the land in *United Equities* was to be valued as subject to the lease, the use limitations in the lease likely had little or no material effect on value because the lessee was permitted to use the land for a garage or "for any other ordinary business." *United Equities*, 8 A.D.2d at 401. Similarly, in *Goldstein v. 12 Broadway Realty*, although the appraisers were directed to value the land subject to the lease, the court held that "the lease imposed absolutely no restrictions" on the use of the land because the lease permitted the lessee to demolish the existing building and "construct any type of 'new building or buildings' without restriction." *Goldstein*, No. 650476, Order & Judgment, June 27, 2011 (Sup. Ct. N.Y. Cnty.), aff'd 89 A.D.3d 590 (1st Dep't 2011).

10. 55 Misc.2d 483 (Sup. Ct. N.Y. Cnty.), aff'd 28 A.D.2d 1209 (1st Dep't 1967), 22 N.Y.2d 846 (1968).

11. *Plaza Hotel*, 22 N.Y.2d at 849.

12. *Plaza Hotel*, 55 Misc.2d at 487.

13. *936 Second Ave.*, 10 N.Y.3d at 632 (quoting *Plaza Hotel*).

14. 88 N.Y.2d 716 (1996).

15. *Id.* at 718-19.

16. *New York Overnight Partners*, 217 A.D.2d 20, 30 (1st Dep't 1995).

17. No. 603664/05, 2007 N.Y. Misc. LEXIS 6595 (Sup. Ct. N.Y. Cnty. Aug. 20, 2007), aff'd 55 A.D.3d 416 (1st Dep't 2008).

18. *Manhattan Church*, 55 A.D.3d at 417.

19. *Id.*

20. 18 A.D.3d 241, 242 (1st Dep't 2005).

21. *Id.*

22. 295 A.D.2d 161 (1st Dep't 2002).

23. RPL §339-a(11).

24. Appraisal Institute, *The Appraisal of Real Estate*, 13th ed., at 278-79.

25. In practice, the rental provisions of most ground leases prohibit decreases in the nominal amount of the ground rent, so even if the hypothetical value of the land were to fall, the rent would remain unchanged. However, such provisions do not protect the lessor against financial loss in real terms, as a result of factors such as market appreciation and price inflation.

26. *United Equities*, 8 A.D.2d at 404.

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