

Question of the Month: Are ground lease rent resets deal killers? How to structure rent resets - by Daniel Shirazi

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One of the biggest “deal killers” during ground lease negotiations circles around the issue of whether or not to include a rent reset in the ground lease. In general, rent resets are used to protect the landlord (lessor) from inflation which in turn can increase future ground rent paid by the ground tenant (lessee). As a consequence, the lessee is reluctant to accept a rent reset whereby “killing the deal.” However, crafting language to protect both the landlord and tenant can help keep the deal “alive.” Most of the time, unfortunately, the discussion surrounding rent resets is not properly handled because the parties do not have a proper understanding of the specifics and reasons for these resets. In order for a ground lease to make sense, the rent reset clause must take into consideration the needs of both the lessor and lessee.

Today, ground leases are being utilized more and more to creatively maximize value for both the

lessors and the lessees. A ground lease, in essence, is a long-term net lease of land between the lessor and lessee. Depending on the terms in the lease, a ground lease can provide the lessor with substantial benefits while simultaneously allowing the lessee to maximize the assets upside potential.

For example, ground-leased properties have a host of tax advantages for lessors. Lessors will not be responsible for paying the capital gains taxes they may incur if they were to sell the property (although there are instances where capital gain taxes might be incurred). Leasing rather than selling their property via a ground lease allows owners to establish generational streams of income from the property without the responsibility of managing the property.

For lessees, they are not burdened by the upfront cost to purchase the property, therefore having more cash on hand to work on other projects. Depreciation from capital improvements they have made on the property and depending on the lease structure, the rent paid to the lessor can be deducted from their pre-tax income as expenses, whereby decreasing the overall cost-basis for the lessee.

Still, despite the benefits, one of the biggest issues in ground leases that is often in contention are the clauses regarding the lease's rent reset and how the reset will be calculated at pre-determined dates throughout the lease (generally every 25th, 33rd, or 49th year of a 100-year ground lease). The most common types of rent resets, include but are not limited to:

Fair Market Value (FMV) Reset

Appraisals are done to ensure that the rents being paid by the lessee are representative of the property's current fair market value. The danger for the lessees is that in many cases the rent that is being paid is substantially less than the current FMV resulting in a dramatic rent increase. However, dramatic rent increases can be avoided if a rent floor and ceiling has been established during lease negotiations. Generally, the rent floor would be that the rent cannot be lower than the current rent and the ceiling would be that the rent cannot exceed a certain amount.

The Lotte New York Palace hotel is set to have a rent-reset based on a fair market value reset in 2023.

SL Green Realty Corp. is also set to have a rent-reset at 625 Madison Ave. based on the property's fair market value in 2022.

Consumer Price Index (CPI) Reset

In many cases rent resets and structure are determined using the Consumer Price Index also known as a CPI. An increase in the CPI over a given period (usually in the 25th, 33rd, or 49th year of the lease term) and the loss in the property value is compensated by a proportionate percentage increase in rent that is calculated based on the change to the CPI, thereby protecting the lessor from inflationary pressures. Using the same rent floor and ceiling discussed above can alleviate the lessee's risk.

Set Escalation

Set escalation clauses are very simple and easy to underwrite. Set escalation clauses usually calculate rent increases by (i) taking an agreed upon percentage and then multiplying it by the then current rent or (ii) agreeing that the rent will increase to a set number (e.x. from \$1 million to \$2 million). This method allows both parties to know the exact rent amount at any given point during the course of the lease.

RFR Realty struggled to refinance their mortgage on 390 Park Ave. due to a set escalation clause in which the ground lease rent was set to increase to \$20 million in 2023 relative to the current \$6 million.

Another example, the Abu Dhabi Investment Council and Tishman Speyer were forced to put up the Chrysler Tower for sale this past January due to their rent-bill ballooning as a result of a rent reset. After paying \$7.75 million in 2017, the rent in 2018 after the rent reset was \$32.5million, an increase of more than 400%.

Highest and Best Use Reset

One method of calculating rent increase that has been causing issues for many iconic ground-leased properties is the method of increasing rent based on the property's "highest and best use." This is particularly true for areas where former business/office districts such as Park Ave. South and the Financial District have seen a huge rise in luxury residential development. Under this method of calculating rent resets, the rents are determined based on what is appraised to be the most profitable asset type for that parcel of land regardless of what currently exists on the plot of land. Tenants may find themselves stuck with an office building whose highest and best use is residential, but the tenant has neither the financial means nor the ability to convert the property type. If a lessor is stern on using this method, the lessee must request rent concessions in the form of free rent or reduced rent while they are repositioning the property.

Rent reset clauses should be collaboratively determined and meticulously reviewed before either party agrees to sign a lease. This is crucial to ensure that the terms are fair and also helps to avoid any potential problems that may arise. There is no reason why the rent reset should continue to be a "deal killer." Ground leases are used to benefit both parties in a transaction; the rent reset clause should be no different.

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