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Rethinking the ground lease

Inflation-based rent solved one problem for these long-term deals, but is now creating another

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By Kathryn Brenzel

Vornado Realty Trust says the land beneath its office building at 330 West 34th Street is worth $145 million. The land's owner, Haymes Investment Company, claims its value is $225 million — entitling Haymes to more than $5 million in additional annual rent.

Assuming no further hikes, that would be nearly $170 million over the course of Vornado's 30-year lease. Vornado and Haymes are suing each other to make their respective valuations stick.

Ground leases, in which a party agrees to develop a vacant property that will eventually be returned to the owner, often after several decades, are ubiquitous in New York City. But so are the legal battles they cause.

Such disputes have embroiled some of Manhattan's most iconic properties, including the Chrysler Building, the Plaza Hotel and Lever House. Nearly all of them spring from disagreements over how to calculate future rent.

Historically, rent is reset for these long-term leases every 20 to 30 years, often based on the estimated fair market value of the property if it were still a developable plot. The discrepancy between how appraisers interpret this often invites litigation.

To avoid that, some have opted for incremental increases based on inflation. This newer model worked when inflation was steady, providing relatively predictable rent growth. That dynamic has changed dramatically.

"There has been a shock to the marketplace," said Tzvi Rokeach, a partner at Kramer Levin, during an industry event in May. "Just slow, periodic escalations over time are not going to work."

For the 12 months ending in March, the Consumer Price Index increased 8.5 percent, the largest annual jump since December 1981, according to the U.S. Bureau of Labor and Statistics. This could spur parties in ground leases to revisit how they structure rent resets, potentially opting for other models, such as those based on a building's gross revenue. But that could lead to the same discord that drove some land owners and lessees away from the fair market valuation structure.

"The problem is that it is fertile ground for disputes," said Joshua Stein, a commercial real estate attorney. "Any opening you leave, that is the opening that is going to screw you."

Getting creative

With decades-long lead times, parties sometimes start fighting over impending rent hikes years in advance. The battle over the rent reset at 625 Madison Avenue, for example, has been brewing for a few years, with the ground rent expected to jump from $4.6 million to as much as $50 million. The fight escalated in December when SL Green sued owner Ben Ashkenazy over the rent reset process.

At the office building One Penn, owner Vornado is staring down a significant rent reset in June 2023. On an earnings call in May, CEO Steve Roth said the real estate investment trust expects its ground rent to jump to $25 million to $26 million, up from $2.5 million. Roth noted, however, that the arbitration process will be different from the one with Haymes on West 34th Street and that Vornado can "easily handle" rent of $26 million.

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>
> **JOSHUA STEIN,** ATTORNEY ON CRAFTING LEASES

In the case of West 34th Street, Vornado has accused the appraiser, who selected the higher estimate put forward by the landlord's appraiser, of failing to disclose potential conflicts related to a business relationship.

Speaking generally, Adam Gilbert, a partner at Nixon Peabody who focuses on commercial litigation and real estate valuation issues, said disputes often arise from "less than crisp drafting" of leases. Market fluctuation can also affect valuations. After the economy collapsed in 2008, appraisers had few land sales for comparisons and turned to alternative methods to assess properties.

"In a stable marketplace, you will see perhaps less of a difference in valuation," Gilbert said.

As real estate investment trusts, Vornado and SL Green are limited in how they can negotiate rent resets, but some landlords and tenants have gotten creative. Janice Mac Avoy, a partner in Fried Frank's real estate litigation department, said appraisals based on the fair market value of the land can make it more difficult for the tenant to secure financing, given the threat of an unknown and potentially massive rent hike.

She said landlords and tenants have turned to alternatives in recent years, including flat percentage increases, as well as those based on CPI and gross revenue. She expects the current market uncertainty to drive more parties to try these and other models for new ground leases and when negotiating renewals.

“A smart landlord who is looking at the long term is going to realize there is something in it for them to agree to modify those provisions,” she said, noting that the financial survival of the tenant is often in the land owner’s best interest.

To protect tenants against inflation, land owners can cap rent increases that are based on CPI. But most private owners do not favor such limits, said David Eyzenberg, president of Eyzenberg & Company, an investment bank that advises land owners on ground lease structures and raises capital for leasehold and leased fee transactions.

“It would be stupid to start with caps today,” he said, noting that owners would lose out if inflation exceeded them.

Sometimes owners will offer a compromise where the first few years of rent increases are uncapped, followed by a period when they have ceilings or a shorter time frame between rent resets.

Rokeach thinks land owners and lessees may increasingly look to a building’s gross revenue to determine ground rent, though he acknowledged that the model comes with its own challenges.

During a down market — during the pandemic, office and retail tenants struggled to pay rent and vacancy rates soared — basing rent on gross revenue could spell disaster for a landlord. Owners also sometimes suspect tenants will find ways to exclude certain income from revenue totals to drive down the ground rent, he said.

Stein echoed this concern, saying a ground lessee could artificially lower the rent levels for its subtenants. He did not dismiss the model entirely, however.

“It is something that has a ring of fairness to it,” Stein said. “You are protecting the tenant from an uneconomical situation.”

Eyzenberg said that model gets away from the purpose of a ground lease: to economically separate the land itself from whatever asset is developed atop it.

Stein said the expectations and standards for ground lease deals change “glacially,” so it will likely take time for ground leases to reflect today’s market turbulence. Bob Knakal, chair of New York investment sales for JLL Capital Markets, said the agreements will still need to rely on historical data and projections on where the market is headed.

“Ground leases are typically for 99 years,” Knakal said. “You can’t base a 99-year deal on one moment in time.”

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