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Negotiating a Building's Ground Rent

Navigating a Contested Land Valuation

By Y. David Scharf and Brett D. Dockwell

Many co-ops in New York lease, rather than own, the land beneath their apartment building. For the board of a leasehold co-op, navigating a contested land valuation, in which the amount of the co-op's ground rent is determined through arbitration, can be a daunting process. Much of the action plays out seemingly beyond the board's control, in an extended battle among appraisers, arbitrators and lawyers, with the outcome dictating the co-op's financial position for years to come. During the process, the prospect of higher maintenance fees to cover the new ground rent will generate shareholder anxiety and adversely affect the marketability of co-op apartments. As a result, the board will feel pressure to reassure shareholders, while remaining candid about the potential for an unfavorable outcome.

To manage these challenges, the board must have a solid understanding of the valuation process and its context. This article outlines the contested land valuation process and some of the broader considerations the board should have in mind as it navigates the process.

Approaching a Ground-Rent Reset Date

Most ground leases run for an initial term of about 30 years, followed by a series of optional extension or renewal terms that can be exercised by the co-op. The renewal terms in most ground leases are 15 to 25 years, and the total duration of the lease if all extension terms are exercised is typically 99 years. To account for changes in economic and market conditions over this long time frame, the ground lease may contain a rent-escalation clause. Alternatively, as discussed here, the ground lease may provide that the amount of the rent can be reset based on the fair market value of the land, as determined through

arbitration, usually at intervals of 10 or 15 years. The ground rent will be a straight percentage – normally about 6 percent – of the land's market value.

As a ground-rent reset date approaches, the co-op board will consult with its counsel and will normally retain an appraiser who is experienced in valuing commercial real estate. The appraiser will provide the board with a preliminary valuation of the land (likely a range of potential values), which should enable the board or its managing agent to estimate the potential increase in the co-op's ground rent and its effect on shareholder maintenance.

Once the board has this information, it will need to decide whether to attempt to negotiate directly with the landowner over the new ground rent. Some ground leases require such negotiations as a precondition to arbitration. By negotiating a new rent, the parties can circumvent the arbitration process, which can take a year or more from the appointment of arbitrators to the final determination of the new ground rent. Furthermore, unlike judges, arbitrators charge the parties directly for their time, and these fees, together with those of the co-op's experts and attorneys, can be substantial. Negotiating a new rent obviously benefits the parties to the extent it avoids the expense, time and uncertainty of arbitration.

Perhaps more importantly, by negotiating, the parties can tailor an agreement to their particular interests in ways that arbitrators cannot. Under most ground leases, the arbitrators of a rent dispute may only determine the market value of the property; any rulings that exceed the arbitrators' mandate under the lease will be unenforceable. By contrast, the parties themselves are free to strike whatever bargain they want. For example, the parties can negotiate a graduated rent payment schedule, which can reduce the size of a rent increase at the beginning of a new rent term. Likewise, they can negotiate lease extensions, the sharing of any retail or commercial revenue from the property, or even the co-op's purchase of the land. In any such negotiations, the amount of the ground rent will be only one of several terms at play.

Such flexibility can be critical for the co-op as it approaches its final renewal term under the ground lease, because upon expiration of the ground lease, the land and the co-op building will revert to the landowner, and the co-op's shares will become worthless. To protect shareholder value, the co-op board will want to negotiate an extension of the term of the ground lease, or the purchase of the land, well before the ground lease's final 30 years. Once the ground lease enters that terminal phase, co-op units will become difficult to sell because prospective purchasers will be unable to obtain traditional mortgage financing and will be, in any case, reluctant to buy a depreciating asset. In such circumstances, the amount of the ground rent will be, at most, a secondary concern.

The Appraisal Process

Absent an agreement between the parties, a new ground rent will be determined through arbitration. (In the rare instance in which the ground lease does not include an arbitration provision, the new rent will be resolved through a court proceeding.) Most leases mandate tri-party arbitration – each side appoints its own arbitrator, and the two arbitrators agree on a “neutral” third. Arbitrators in contested land valuations are typically appraisers themselves, though they do not prepare their own reports and will instead rely entirely on the reports submitted by the parties’ appraisers.

One of the appraiser’s first tasks will be to determine the highest and best use for the land – that is, the legally permissible use of the land that maximizes the land’s economic return. Such a use may not be a residential co-op, but rather an office or condo building or a hotel. Valuing the land according to its highest and best use, rather than its actual use as a co-op, may seem counter-intuitive, but it reflects the fact that the co-op leases the land, not the co-op building.

The appraiser will also consider any restrictions on the use of the land, such as zoning regulations that prohibit certain uses or impose architectural and design limitations. Such restrictions can significantly reduce the land’s value. In addition, the ground lease itself is an encumbrance on the land that affects its value; in the open market, land that is subject to a lease will generally sell for less than land that is available for immediate development. Under New York law, the lease itself must be considered as an encumbrance in valuing the land, unless the language of the lease expressly states otherwise.

To support the appraiser’s assumptions, the co-op may retain experts on topics such as land use, retail leasing, condo pricing, and financing and construction costs. The parties’ appraisers and experts prepare written reports, which they submit to the panel, followed by rebuttal reports. After reviewing the reports, the panel will hold hearings.

Arbitration Hearings

An arbitration hearing is similar to a court trial, with each side offering evidence and examining and cross-examining witnesses. However, arbitration is much less formal than litigation, and courtroom rules of evidence and procedure do not apply. Disputes regarding evidence or procedure, or the availability of discovery, will be resolved by the arbitrators in their discretion. Hearings normally take place at the offices of the parties’ counsel, and the proceeding can last anywhere from a few days to a few weeks.

During this time, the parties are normally permitted to consult privately with their respective party-appointed arbitrators.

Once the hearings are concluded, the arbitrators may ask each party to provide a memorandum that summarizes the appraisal reports, evidence and witness testimony from that party's perspective. The arbitrators will then commence deliberations, at which point each side will be barred from communicating with any of the arbitrators, including its appointee, until the arbitrators render their decision.

The Decision

The arbitrators will issue a decision typically within 30 to 60 days after the conclusion of the hearings. This decision normally consists of a single sentence or two setting forth the panel's conclusion as to the land's fair market value. Arbitrators are not required to explain the reasoning behind their value conclusion, and arbitrators rarely provide any reasoning in their written decision. If the decision is issued after the new rent term has already begun, the co-op may owe back rent, which may be subject to interest under the lease.

The panel's decision will be the final word on the property's value for the duration of the rent term. Under both New York and federal law, an arbitration decision will be overturned by a court only in rare instances of corruption or bias or other procedural irregularities. Once the decision is rendered, either the landowner or the co-op will typically file an action in New York state court to obtain judicial confirmation of the award. Once confirmed, the arbitration decision is enforceable in the same manner as a court judgment, although in the majority of cases the co-op and the landowner are able to reconcile the new rental amount between themselves, without further recourse to arbitrators or the courts.

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