The Most Important Issue in Every Ground Lease

By Joshua Stein

When a property owner and a developer negotiate a long-term ground lease of a development site, one issue overshadows almost all others: how should ground rent adjust over time to protect the property owner, as lessor, from inflation? And how can the lessor participate in future increases in value of this particular site, which may or may not correlate with inflation? At the same time, though, how can the developer assure that its leasehold position will also maintain its value without becoming overwhelmed by rent payments that no longer make any business sense?

TYPICAL APPROACH • Lessors and lessees typically resolve these concerns by agreeing that every two or three decades, they will reappraise the development site that the lessor originally delivered to the transaction. In my experience, the ground rent will then adjust to equal six or seven percent of the then-current fair market value of the site, i.e., whatever someone would pay to purchase the development site. Until that happens, rent may go up a bit every year or few years[1]—or not, especially in older ground leases. In most cases, the rent never drops.

The reference to six or seven percent in rent adjustment formulas has remained remarkably stable for quite a while, even through the very low interest rates of the last few years.

Although ground leases typically use the approach just described, prospective ground lessees sometimes worry that if a ground rent adjustment occurs in a low-interest rate period like today's, the typical approach may overcompensate the lessor, leaving the lessee paying ground rent that may feel excessive. Once the adjustment occurs, this approach might diminish or even destroy the value of the leasehold estate.

LENDER'S CONCERNS • Leasehold lenders, generally even more conservative than developers and investors, will likewise fear that a massive increase in ground rent at some distant date will diminish or destroy the security for their loans. Though "cowboy" developers may sometimes take risks, lenders rarely have the same mindset, and they never forget that the obligation to pay ground rent is always structurally senior to any leasehold lender's collateral.[2]

In response to these concerns, a lender or prospective lessee will sometimes suggest a "cap" on ground rent adjustments. Typically, though, a lessor will regard any such proposal as a non-starter, because it necessarily undercuts the protection that the lessor wanted to achieve through the future ground rent adjustments.

Applying a fixed percentage to future land values will create problems for both a lessee and its lender—and wonderful results for the lessor—if, at the moment of the rent reset, valuations in the larger real estate market use capitalization rates significantly below six percent. At any such time, real estate values will reflect a capitalization of future income at, say, four percent, but the ground lease will require payment of ground rent at, say, six percent of that capitalized amount, which may put the lessee in an untenable position and undercut or destroy the value of the lender's collateral.

LINKAGE TO INTEREST RATES? • Some ground leases try to mitigate these risks by replacing a fixed adjustment percentage with a percentage tied to interest rates at the time of the rent reset. The parties might choose a long-term rate like 20-year Treasury securities, or, more unusually, they might use a shorter-term one like the prime rate. In either case, they would look at the average level of that rate over some period and then add on some spread.

Although some commentators may have seen a trend toward this type of formula, I have not seen it. Like many of the comments in this article about "typical" practice, my failure to note the trend might only reflect the particular universe of ground lease transactions that I have personally been involved with or seen recently. Or it could reflect a view in the market that in the long run—i.e., multiple business cycles—six or seven percent has worked reasonably well, and that there's no reason to believe it will stop working anytime soon.

Of course, if a "typical" rent reset occurs in a real estate depression—or at any time when valuations use very high capitalization rates—the lessee may get lucky.

As an alternative, a ground lease could theoretically refer to some objective third-party index for long-term capitalization rates for real estate investments at the time of the rent reset. And, very occasionally, the revaluation might direct the appraisers to determine the new rent based generally on market conditions for newly negotiated ground leases at the time of the rent reset. In other words, the rent would adjust to equal "fair market rental value" at the time of adjustment, without using any formula to derive the rent adjustment from land value or anything else. The drafters of the ground lease must still define with absolute clarity how fair market rental value is to be determined. They also must define any assumptions the appraisers should consider in that process.

VALUATION ON A RANGE OF DATES • Ground lease negotiators sometimes suggest that instead of valuing the site on a specific date, the valuation should look to a range of dates, using the average value over, say, a three- or five-year period whose midpoint is the intended rent reset date.

That approach may make some sense. Suppose a rent reset used a single fixed valuation date of October 1, 2008, two weeks after the Lehman Brothers bankruptcy filing. Given the state of the financial and commercial real estate worlds on that date, the lessor would probably feel victimized by a very low valuation. Going forward, that particular lessor might favor using an average of the values on multiple dates over multiple years.

Valuation on a range of dates would not need to require a complete reappraisal each time; perhaps the only full appraisal would precisely tie to the midpoint date. The other dates could require only adjusted appraisals, taking into account only certain elements of the appraisal analysis, such as then-current capitalization and vacancy rates.

Lessors and lessees generally prefer, however, to avoid the time, expense, and logistical difficulties of dealing with multiple appraisal dates. They tend to feel that way even though an average of multiple appraisals might make the calculation less arbitrary. The use of a single bright-line date introduces a greater element of luck for both parties, but both seem generally willing to take their chances.

The need to periodically revalue the site for the purposes of ground rent adjustment practically invites litigation or arbitration. For obvious reasons, lessor and lessee will have dramatically different ideas of the value of the land, or of how the appraisers should proceed, particularly as markets and other circumstances change. The exact wording of the ground lease, and how it addresses those possible changes, becomes crucially important in determining what exactly the appraisers should appraise and how they should go about it.

For instance: should the appraisers appraise raw land, or should they include improvements? Should they include the improvements that existed on the site when the parties signed their lease, or whatever improvements exist at the time of revaluation? This is a common disagreement. The lease should entirely pre-empt it. In general, the appraiser should try to replicate whatever existed when the parties signed the lease, usually vacant land. To avoid confusion, the lease should say that as clearly as possible.

GROUND LEASES OF MORE THAN JUST GROUND • If improvements existed at lease inception, and the lessor initially demised those improvements to the lessee along with the underlying "ground," the market will often still regard the transaction as a "ground lease," even though it covers existing improvements and not just ground. The characterization as a "ground lease" would depend largely on whether the lessee's rights and obligations looked more like ownership (an investment transaction and typically regarded as a ground lease) or mere rights of occupancy not readily salable or financeable in the market (a "space lease").[3]

If a ground lease covers improvements that existed at the time of lease inception, the rent reset should usually consider only the improvements as they existed at that time. The rent reset clause might, however, require the appraisers to take into account any upgrading or expansion that the lessee accomplished. This effectively forces the lessee to pay rent in exchange for value that the lessee rather than the lessor created or provided. Forcing the lessee to pay twice for whatever (re)development the lessee accomplished—once when doing the work, a second time by paying adjusted rent based on the completed work—hardly seems "fair." Fair or not, the lease language should resolve that question and not leave it to courts, appraisers, and arbitrators.

FUTURE CHANGES IN THE SITE • Any ground lease negotiator also should consider possible future disconnects between the development potential of raw land (assumed to be unimproved) and the actual physical development that exists on the site at the time of any rent reset.

For example, changes in zoning or other law could change the value of the site, if it were priced as hypothetical raw land. For the rent reset, though, the parties need to think about one minor detail: if the transaction played out as the parties originally anticipated, then by the time of the rent reset the lessee will have already built improvements on the land. At the time of the rent reset, those improvements will probably not be obsolete—i.e., ready for demolition or major redevelopment.

If zoning at the time of the rent reset would allow much more development than the building already in place at that time, then that upzoning does not help the lessee very much. If the lessee must pay rent for newly created development potential that the lessee cannot really use, then the lessee's leasehold may no longer make economic sense. Conversely, if zoning changes have reduced the permitted development on the site, but the lessee's improvements are now overbuilt and can remain as a legal nonconforming use, then the lessor would argue that the revaluation process should ignore the down zoning.

Another question along those same lines: should newly discovered environmental issues affect the land value? The answer will depend in part on which party bears the risk of unexpected environmental conditions, taking into account the terms of the ground lease. And what if some government decides to issue a landmark designation for the existing improvements?

Lessors and lessees might also find themselves fighting over whether any appraisal of the land should, in appraising the land, "consider the terms of the lease," a concept that appears in many older ground rent adjustment clauses and a few newer ones. The whole concept seems circular. That's because the value of the lessor's land, if considered subject to the terms of the lease, will depend largely on the amount of the ground rent, assuming the lessee is reasonably likely to actually pay that ground rent. Thus, it may not make sense—it seems circular—to consider the ground rent in measuring the value of the land for purposes of determining the ground rent.

One can eliminate the circularity by deciding that the parties probably meant that any valuation should take into account any lease terms that limit permitted uses or other rights of the lessee.

For example, land will have a higher value if it can be used for "any permitted use." If, on the other hand, the lease says the lessee can use the site only to construct a "car wash with ancillary coffee shop," regardless of what the law might then allow, then that limited range of uses—if applied to the land value as part of the appraisal process—will drive down the value of the land. In this case, "considering the terms of the lease" means accounting for how much those terms decrease the value of the land. It makes sense: if the lease only allows the lessee to construct a car wash with an ancillary coffee shop, the lessee should not pay rent for the right to build a 50-story office building, even if zoning law might allow it.

But "considering the terms of the lease" could also mean something more. It could also mean the appraisers should consider anything else in the lease, except ground rent, that increases or decreases the value of the lessor's position. For example, if the lease gives the lessee a below-market purchase option, this will lower the value of the lessor's position. And what if the lease requires the lessor to deliver to the lessee some nonstandard but expensive service? Is that a term of the lease that the appraisers should consider in valuing the land "considering the terms of the lease"? Again, these are fascinating questions. Litigators and courts and expert witnesses could have a lot of fun and deep thought resolving them. We shouldn't give them the chance. Again, the words of the lease should leave no uncertainty.

If the lease has only a decade or two remaining in its term, then an appraisal "considering the terms of the lease" should perhaps consider the fact that, as an economic matter, the lessee doesn't have enough "useful life" left to justify a major construction or redevelopment project. Should the appraisers consider that as a negative in measuring the value of the land "subject to the lease"? Isn't the short remaining life of the lease a term that ought to be considered?

Over an extended period of time, differences of opinion on these and similar issues translate directly to dollars—lots of them. Any careful lease drafter should prevent the issue by avoiding any suggestion that the appraisers should "consider the terms of the lease." Instead, the appraisal clause in the lease should state exactly what circumstances warrant consideration, and what assumptions the appraiser should make. If the appraiser should consider the narrow scope of uses permitted under the lease, that's what the appraisal clause should say. If other particular provisions of the lease should increase or decrease value, identify those. And if the appraiser should disregard the terms of the lease entirely, that's what the appraisal clause should say.

Anyone writing a land value rent reset clause in a lease should consider asking appraisers whether they can understand and apply the language as written. After all, the hope is that appraisers rather than lawyers or courts will be the parties charged with interpreting and applying the words in the lease.

Even if the lease handles the panoply of appraisal issues correctly, the "standard formula" described above—six or seven percent of land value—will never precisely correlate with what the adjusted rent "should be" according to some "fair" view of the world. It is a crapshoot. But lessors and lessees often still take their chances, recognizing that there may be surprises while comforting themselves by knowing that this is the way everyone does it (or at least many people do it), and that lenders have underwritten and financed similar leaseholds for decades.

IS THERE A BETTER WAY? • Lessors and lessees do sometimes try to find a logically superior and perhaps less risky way to handle ground rent adjustments. They often start by suggesting that the ground rent should reflect the lessee's revenues, at least in part. The lessor could receive some percentage of "gross revenues," perhaps after modest deductions, and perhaps with a floor. That percentage might reflect the expected ratio between the value of the land and the value of the lessee's completed development project.

It sounds reasonable. But what if the lessee does not try very hard to rent space in the completed development project? Or occupies the space itself to conduct business? Or subleases the space to a chain store at below-market rents while simultaneously entering into an above-market lease with the same chain store in another state? What if the lessee does a lousy job with subleasing, or fails to invest the capital necessary to achieve the highest rents? And what should the lease allow the lessee to deduct? Leasing costs? Capital expenditures necessary to attract space lessees? If the lessee borrowed money to improve the property, should the lessee have the right to deduct debt service? Interest? At what rate? How does the lessor know the lessee is not lying or artificially reducing its revenues? Before long, the exercise reinvents the Internal Revenue Code.

If a lessor and a lessee do decide to go down that road, then they (particularly the lessor) should take a few measures to prevent disputes. Keep it dumb and simple, avoiding exclusions, complex characterizations, and fine lines whenever possible. They all provide fertile ground for misunderstandings, mischaracterizations, strategizing, gaming the system, and disputes. Try to give the lessor a low percentage of a broadly defined variable without too many deductions. Gross revenue with no deductions has a lot of appeal to it. Paint with a broad brush. Think about every possible circumstance that might occur and how it might play out given the lease language and definitions. Finally, ask an appraiser and a lender how they would interpret, and react to, whatever "brilliant" contingent rent clause the parties think they want to perpetrate.

Any contingent rent formula in a ground lease might also award the lessor a small percentage of capital transactions—lease assignments, refinancings, or other transactions tantamount to either. Here, too, the principles and issues above will arise, including the risk of recreating the Internal Revenue Code. And, again, any uncertainty about line drawing or inclusions or exclusions will breed disputes down the line.

For example, does a "refinancing" include the case where a lessee holds its leasehold free and clear, and places an entirely new mortgage on the leasehold? Can it be a "re"-financing if no financing existed before the transaction closed? Does "refinancing" refer to placing any form of financing on an asset that had previously been financed in some other way at any time, or does it merely refer to replacing one mortgage with another? Should the lessee's first construction loan be "exempt" from any payment to the lessor? First permanent loan? If multiple sales of the leasehold occur, should the lessor participate only in the "profit" since the last sale? What about multiple refinancings over time? If the lessor participates only in the "new loan proceeds," what if some of those loan proceeds arose only as a result of amortization of the previous loan?

These questions only scratch the surface of the issues that can arise once lessor and lessee start down the contingent rent road.

SMALL PERCENTAGES—NOT SO SMALL • Setting aside the many opportunities for dispute that arise in measuring any contingent rent, even a very low percentage of the lessee's gross revenues, can place a very significant burden on the lessee, and give the lessor a correspondingly significant stream of contingent rent. Suppose, for example, that the lessee agrees to pay the lessor three percent of a truly gross measure of revenue, with no meaningful deductions at all. Three percent sounds like a really small percentage.

Assume, however, that the lessee's operating expenses, real estate taxes, and insurance consume 50 percent of gross revenue. Assume ground rent consumes another 10 percent and debt service another 20 percent.

After those deductions, the lessee really gets to keep only 20 percent of the gross revenue. The lessor's three percent share of that gross revenue represents almost one-sixth of the lessee's bottom line. Moreover, a lessee might operate at a loss even though gross revenue seems substantial. In other words, instead of adding up to 80 percent of gross revenue the lessee's expenses could add up to 105 percent.

In all these cases, paying even a very small percentage of gross revenue to the lessor can put quite a dent in the lessee's bottom line. Assuming the lessee will consider the concept at all, the lessee might respond in part by trying to credit one ground rent stream against another—similar to the operation of a natural breakpoint with percentage rent in a retail lease or a right for a space lessee to offset real estate tax escalations against percentage rent. Similar considerations arise if the lessor will receive a percentage of refinancings, lease assignment proceeds, or other capital transactions.

As a variation, the parties could conceivably measure the lessor's participation in the lessee's operating revenue based not upon the lessee's actual earnings, with all the headaches that entails, but instead based on how much the lessee reasonably "should have earned" based on market conditions at the time of determination.

If the project consists of a an up-to-date office building, for example, the contingent rent determination could assume the lessee achieves the same occupancy rate and rental levels as other comparable buildings in the market, and expense levels consistent with similar buildings. In each case, the measurement would disregard the lessee's actual financial performance. The lessee would then pay contingent rent based on these benchmark market-based numbers.

Although this idea may sound practical or at least creative, the parties still must consider the possibility of future changes in circumstances, starting with a change of use of the building. And the lessee will worry that circumstances or issues peculiar to this property will prevent the lessee from achieving strong enough actual results to match the benchmark-based contingent rent the lease requires the lessee to pay.

Yet another possibility: the developer might agree to give the lessor a small "carried interest" in the lessee entity. Any carried interest will, however, raise another host of issues, some of them variations on the problems discussed earlier in this article. Many of the carried interest issues will arise from the fact that the developer will probably invest substantial additional capital to generate the anticipated value and return from the project. Another set of problems might arise from the lessor's concern that the developer could somehow redirect or dilute project income in a way that makes the carried interest worthless. Those two groups of issues only scratch the surface of what a carried interest might entail.[4]

If the parties do not want to agree to any form of contingent ground rent, the question then becomes: how else can the lease protect the lessor from inflation and equitably compensate the lessor, while protecting the lessee from destruction of its leasehold through an unaffordable rent increase?

OTHER INDEXES • One might tie periodic major rent adjustments to an index. For example, rent might rise with the consumer price index. People in real estate, particularly lenders, usually think the CPI goes up faster than real estate values and rents; hence, they may propose a cap on the adjustments.[5] But if the parties "cap" any periodic rent adjustment, then the lessor will not achieve its goal of protecting itself from inflation.

Perhaps the parties can find an index better than CPI; Class A office rents, average daily rate for hotel rooms in a certain market stratum, real estate tax assessments, or retail rents are all possibilities, in each case for some defined local geographical area. Real estate professionals may have varying degrees of confidence in any possible index. They would need to choose accordingly. Future changes in the chosen index would drive changes in the ground rent, regardless of what a particular lessee does or earns in the demised premises. Such an index could make sense, especially if it matched likely uses of the site. A combination of multiple indexes might also work, though it might not ultimately differ significantly from measuring contingent rent based on a marketplace benchmark of what the lessee "should have earned," as suggested above.

Ground leases once required lessees to pay rent equal to the dollar equivalent of a certain amount of gold. The federal government outlawed such clauses in the 1930s as part of the New Deal. Gold clauses became legal again for any "obligation issued after October 27, 1977."[6] A federal court validated such a clause as recently as 2008.[7] Gold clauses certainly would have protected lessors from inflation in the recent past. In the last few decades, gold clauses would have produced dramatic rent increases given the ever-increasing dollar value of gold, i.e., the plummeting value of the dollar as against gold.

Lessees, however, would fear a disconnect between the price of gold and the "right" rent, in dollars, for a given site over time. During the last few decades, any such fear would have been entirely justified. Looking ahead, however, a lessor may worry that gold has run its course, or that during the ground lease term gold might no longer function as a reliable repository of value. A lessor may also worry that a gold clause may not accurately reflect the future value of this particular site. The lessor might care more about that value than about the general value of the dollar.

RECALIBRATION OF RELATIVE VALUES • The parties could also try to devise a rent adjustment structure in which, over time, the lessor and the lessee will each maintain a position whose value always equals about the same percentage of the value of the project as a whole. In other words, whatever rent reset formula the ground lease used, it would contemplate a valuation of both the lessor's and the lessee's position, after taking into account the contemplated adjustment. Then the ground lease would also add a requirement—and, to assure it, perhaps another rent adjustment—that at the end of the day each party would maintain about the same percentage of the value of the project as a whole.

For example, if the initial ground rent were calibrated to give the lessor a position worth 34 percent of the project as a whole, then any future ground rent would need to be calibrated to maintain that percentage, taking into account market conditions at the time of any rent reset. This approach would still require appraisals and the headaches and uncertainties they create. It would, however, at least address each party's fear that, over time, the rent adjustment would shift too much value into the other party's pockets.

Although recalibrating relative values has a theoretical appeal to it, it is not at all market standard. In fact it is unheard of. And its appeal is complicated by the need to consider additional capital investment the lessee will make in the project, to upgrade it and increase its value, or even just to keep it functional and rentable on attractive terms. If the property's value as a whole increases as a result of the lessee's investment and brilliant development, leasing, and management strategies, how does one slice up the resulting profits? The issue becomes particularly troublesome if the lease demises a vacant site; it may be easier in an existing building. But the issues involved may not be all that different from those that arise whenever a ground lease requires appraisal of anything other than the actual building (and underlying land) on the site at the moment of appraisal.

Because of the ever-shortening duration of the remaining lease term, however, the lessee's leasehold estate is "supposed to" decline in value over time, requiring some further adjustment, particularly in the last few decades of the lease term. This could take various forms—each with its own unique bundle of trouble—all beyond the scope of this article, and most requiring substantial consumption of aspirin.

Instead of looking at relative shares of value, the parties might look at their relative shares of overall property income. The lease might start out by providing for a fixed rental stream with fixed bumps. But it could also say that if the lessor's share of overall gross revenue (or, less desirably, net operating income before ground rent) ever drops below a certain percentage, then the lessor can require an increase in ground rent to bring that percentage back to a certain level. This approach is not too different from the percentage rent discussed earlier. It is also a variation on the technique of "debt service coverage ratio" from real estate financing, except it refers instead to a "ground rent coverage ratio," with the goal of keeping it within a certain band.

Conversely, if as a result of those increases in ground rent the lessor's share ever rose beyond a certain percentage, then ground rent would drop, but never below the fixed rent schedule. Arrangements like these can give the lessor a form of participation in future upside without opening up the possibility of making the leasehold estate uneconomic. But, like so many other alternatives discussed in this article, these arrangements come with tremendous definitional issues and hence possible disputes. Moreover, they tempt the lessee to game the system in any number of ways.

RENT ADJUSTMENT TIMING • Anyone who negotiates future contingent rent adjustments in a ground lease should also consider how the timing of those rent adjustments interacts with the timing of a lessee's renewal options. In a lessee's perfect world, each rent adjustment period would correspond to an option term. The lessee would know the adjusted rent before needing to exercise a renewal option. As an equivalent alternative, the lessee could have the right to withdraw the exercise of an option if the lessee didn't like the rent as ultimately determined.

Both of those approaches, though perhaps typical, convert each option into a one-way negotiation in which the rent can only go down from whatever number the rent determination process produced. Of course, the leverage they give the lessee is roughly equivalent to the lessee's right to walk from the lease at any time. That walk-away right always gives any lessee the ability to try to negotiate the rent downward at any time. The ability to not exercise—or withdraw the exercise of—a renewal option creates much the same leverage.

The dynamic changes, of course, if the lessee has significant credit or a creditworthy guarantor, or if credit enhancement measures, such as a security deposit or a letter of credit, back the lessee's obligations. In those cases, the lessee can't so easily threaten to walk away from the lease, so the lessee truly realizes a benefit by knowing the adjusted rent before the deadline to exercise the renewal option.[8]

A more balanced approach might require the lessee to exercise each option before knowing the outcome of the rent determination process, with no right to withdraw the exercise of the option, only the right to walk away from the lease. The renewal options would be disconnected from the rent determination or renegotiation process, putting the parties in the same position—and giving each the same leverage—as if the rent adjustment occurred part of the way through the lease term, rather than as part of the renewal process.

Except for the possible need to conform to "tradition," it seems unnecessary and perhaps even inappropriate to tie the timing of rent adjustments to the timing of renewal options. In any case, it is not "obvious" that adjustment periods should conform to renewal terms.

REAL ESTATE DERIVATIVES? • Ground lessors and lessees might eventually hedge some risks of real estate inflation and ground rent adjustments through insurance or real estate futures markets, in much the same way farmers hedge commodity prices. But commercial real estate is not as fungible as pork bellies and corn. And, after some false starts with real estate derivatives during the boom that ended in 2008, it's safe to assume that brilliant new derivative products are not at the top of anyone's list. Great financial minds may bridge part of that gap, perhaps by insuring against inflation through puts and calls involving long-term TIPS bonds. That too has its risks and costs.

Lease negotiators typically worry that creative structures like those proposed in this article will not work right because of some problem or gap that no one notices until the litigation or arbitration begins and the parties and their counsel take out their magnifying glasses and apply them to the lease. It is a reasonable form of free-floating anxiety when trying to create something new and different that will work correctly for 99 years.

My own many recent experiences as an expert witness suggest that the commercial real estate industry and the lawyers who serve it categorically overestimate their own intelligence and ability to "get everything right" in the context of ever-more-complex deal structures and terms.[9] The more complex and creative the various gradations and nuances become, the more likely the parties will get them wrong, leaving land mines in the lease to produce unpleasant surprises when applied in the real world. The incredibly complex language and multi-page sentences that are so common in today's real estate documents often manage to include some imperfection. And, whenever writers of legal documents try to use words to define some future hypothetical that is intended to replicate a set of present known conditions—pretty much what one does in a land valuation rent reset—the fallibility of lawyers often becomes particularly apparent.

Legitimate fear of complexity, legitimate fear of change, and the constant need to satisfy future lenders will often drive ground lease negotiators back to the traditional rent adjustment formula described early in this article.

Endnotes

1. These annual increases, typically small, add up in a significant way over time. They sometimes take the form of a CPI increase, annually or every few years, subject to a low cap. That cap may apply to either: (a) each increase or (b) all increases, considered as a whole, since the start date. Which party will benefit more from which type of cap will not always be obvious. The measurement of that cap can create room for misunderstandings.
2. This assumes, of course, that the lessor does not agree to join in the leasehold mortgage, sometimes referred to colloquially and incorrectly (and, in the eyes of some courts, almost humorously) as "subordinating the fee." In today's market, that assumption is almost always

correct, so this article accepts it as part of the territory.

3. Can a ground lease demise part of a building? Must a ground lease demise at least some ground as part of the transaction? To define a transaction as a ground lease, the author would look to the character of the leasehold estate created—the terms of the ground lease—and not place great emphasis on whether the lease demises any ground. Others, including perhaps *Black's Law Dictionary*, disagree.

4. Many of these issues also arise in negotiating a joint venture. *See* Joshua Stein, *Agenda for a Joint Venture Agreement*, The Practical Lawyer, April 2010, at 36, (www.pdf2go.org / 165.html).

5. Historically, over any extended period the CPI has actually risen only 2% to 3% a year, despite perceptions of wild inflation over many years. Some periods of very high inflation did occur, of course, but looking back over the long term the CPI has not grown all that dramatically. It has certainly not been "out of control" over the long term. Commercial real estate values considered as a whole over the entire United States have trailed the CPI (except in Manhattan, where they have barely matched it). These statements are all wild overgeneralizations—they should not be relied upon in any way or even taken very seriously—but they do summarize the author's non-authoritative but also nontrivial research in the area. Further insights on these issues will be welcomed.

6. 31 U.S.C. § 5118(d)(2)(1997).

7. 216 Jamaica Ave., LLC v. S & R Playhouse Realty Co., 540 F.3d 433, 441 (6th Cir. 2008).

8. In a typical ground lease, the creditworthy lessee's "walk-away exposure" may not be all that great. Most leases, including ground leases, allow a lessor only two major forms of recovery upon a lessee's default. First, the lessor can sue for the rent every month. Second, the lessor can sue the lessee for the excess, if any, of the fair market rental value over the reserved rental for the remaining lease term, discounted to present value. In a typical ground lease, almost by definition, no such excess exists: the lease has value to the lessee precisely because the ground rent is below fair market value rather than above fair market value. That fact precludes the lessor from suing for a large and attention-getting lump-sum award if a creditworthy lessee decides to walk away. To recover, the lessor must leave the lease in place and keep suing the lessee every month for unpaid rent, which the lessor might not find too appealing. The comments in this footnote may imply that lessors and their counsel should think more about the measure of damages if a creditworthy lessee does decide to walk away from a ground lease. Of course, the lessor may happily recover possession of a completed building and call it a day.

9. For more on this topic, *see* Joshua Stein, *It's Complicated, But is it Right?*, The Mortgage Observer, February 2013, at 12. The author's expert witness assignments mostly involve complex and nuanced documents for large transactions. Aside from ground leases, the line-up often includes joint venture agreements; development agreements; intercreditor agreements; and loan documents, particularly nonrecourse clauses and carveouts. With the help of great minds, these documents cover every possible eventuality perfectly except, it seems, the one eventuality that actually occurs; hence, the litigation.

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