ACREL News

President's Message

Happy Holidays to all, and warmest wishes for a Healthy, Happy and Prosperous 2013!

Thank you!

Thank you for the honor and great privilege of serving as President of ACREL in 2012. It has been a very satisfying and gratifying year with substantial progress in a number of areas. Together, we have provided compelling and useful programming and business opportunities to all of our Fellows. Our commitment to the College's core values of collegiality and respect remain stronger than ever.

Through the Looking Glass at 2012!

Looking back at the 2012 activities of the College, there have been many positive changes increasing our commitment to transparency and best practices for College governance. We have grown to almost 1000 Fellows, and our annual budget approaches $1,000,000. A successful RFP selection process led to an excellent new auditor. We have implemented enhanced financial management and reporting practices, as well as creation of an Audit Committee and a Compensation Committee beginning in 2013.

Even more importantly, we see renewed energy in many of our Substantive Committees. Our education programs increased our College-wide call-in programs (now to be called ACREL Live) and we increased joint external programs with ALI-CLE and the MBA. Newly elected Fellows are taking an active role in substantive committees and committee leadership, as well as speaking and writing opportunities for ACREL programming and within our Substantive Committees.

It's Time to Vote!

I am delighted to report that we have 32 nominations for admission to the College for 2013. Please click on this link, http://www.acrel.org/Private/OnlineVoting/ or go to Administrative/Online Voting in the blue navigation bar on the left on the ACREL website and vote for our 2013 ACREL Fellow candidates. Our Member Selection Committee will

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be hard at work beginning in January to recommend a slate of candidates for selection. New Fellows will be announced in the Spring, and we look forward to all of our new Fellows joining us at our Annual Meeting in beautiful Vancouver in October.

The Weather Outside is Delightful in Naples!

Please be sure to mark your calendar to join us in sunny and gorgeous Naples, Florida March 14-17, 2013. The room rate is very good, and the Naples/ Fort Meyer airports have great service and many choices of airlines. We expect that registration materials for the Naples meeting will be available in early January, and will send out an announcement to all when they are posted on the website.

I send each of you and your families my personal best wishes for the New Year and look forward to a great year for the College in 2013!

Ann

Ann M. Saegert, President

Meetings Calendar

2013 Mid-Year Meeting
March 14-17, 2013
Waldorf=Astoria
Naples, FL

2013 Annual Meeting
October 24-27, 2013
Four Seasons Hotel
Vancouver, BC, Canada

2014 Mid-Year Meeting
March 27-30, 2014
Grand Hyatt Kauai Resort and Spa
Kauai, HI

2014 Annual Meeting
October 16-19, 2014
InterContinental Hotel
Boston, MA

2015 Annual Meeting
October 22-25, 2015
Four Seasons Hotel
Baltimore, MD

STAFF BOX

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One Central Plaza
11300 Rockville Pike, Suite 903
Rockville, MD 20852 301/816-9811
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Editor
Jill H. Pace
Executive Director

A Case Study in the Enforcement of an Exclusive Use Provision

by Arthur J. Menor, Shutts & Bowen LLP, West Palm Beach, FL

On August 13, 2012, Judge Donald L. Middlebrooks of the Southern District of Florida issued his opinion in *Winn-Dixie Stores, Inc. v. Big Lots Stores, Inc.,* --- F.Supp.2d ---, 2012 (2012 WL 3292001 (S.D. Fla., Aug. 13, 2012). This case illustrates some very interesting issues in the realm of exclusive use provisions in retail leases. This case summary is based on a review of the Court's opinion and an interview with Winn-Dixie's lead counsel.

Background

Winn-Dixie has been in a "war" with the "dollar store" brands for over ten years regarding violations of Winn-Dixie's "grocery exclusive". This war has already resulted in several appellate decisions in Florida.[1]

Initially, Winn-Dixie filed suits against individual dollar stores that it alleged were violating exclusives. In most cases, for business reasons, Winn-Dixie did not sue the landlords of the shopping centers in which the offending dollar stores were co-located, instead opting for actions against the co-tenants only.

In 2007, Winn-Dixie won a significant victory in *Dolgencorp*. This case held that the "grocery exclusive" at issue was a valid and enforceable covenant running with the land that was enforceable against a co-tenant not in privity of contract with Winn-Dixie. The Court in this case found that a valid covenant running with the land could be enforced against a co-tenant with notice of the restriction. The Court declined to find that tenants have constructive notice of exclusives contained in recorded short forms of leases but found that Dolgencorp had at least implied actual notice of the exclusive based on being an experienced commercial tenant who knew or should have known that grocery store anchor tenants typically obtain exclusives in shopping center leases. Under these circumstances Dolgencorp had an obligation to make further inquiry of the landlord or Winn-Dixie or to search title to determine whether Winn-Dixie had an exclusive.

Winn-Dixie later decided to pursue a more comprehensive strategy and filed the instant case in Federal Court in the Southern District of Florida in West Palm Beach against Big Lots Stores, Inc., Dolgencorp, LLC, and Dollar Tree Stores, Inc., in connection with shopping centers located in five states -- Florida, Georgia, Alabama, Mississippi, and Louisiana. This case initially involved 69 Dollar General, 48 Dollar Tree, and 19 Big Lots stores. The plaintiff ultimately went to trial on a total of 97 of these stores. The defendants will be referred to in this article collectively and generically as the "dollar stores".

The typical Winn-Dixie grocery exclusive reviewed in this case contains the following key provisions:

"Landlord further covenants and agrees not to permit or suffer any property located within the shopping center to be used for or occupied by any business dealing in or which shall keep in stock or sell for off-premises consumption any **staple or fancy groceries**, meats, fish, vegetables, fruits, bakery goods, dairy products or frozen foods without written

1 *Winn–Dixie Stores, Inc. v. 99 Cent Stuff–Trial Plaza, LLC*, 811 So.2d 719(Fla. 3d DCA 2002) (hereafter, "*99 Cent*"); *Winn–Dixie Stores, Inc. v. Dolgencorp*, 964 So.2d 261, 265 (Fla. 4th DCA 2007) (hereafter, "*Dolgencorp*"); *Dolgencorp, Inc. v. Winn–Dixie Stores, Inc*., 2 So.3d 325, 327 (Fla. 4th DCA 2008).

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permission of the tenant; except the sale of such items in not to exceed the lesser of 500 square feet of **sales area** or 10% of the square foot area of any storeroom within the shopping center, **as an incidental only to the conduct of another business** ... shall not be deemed a violation hereof.” [emphasis added]

Findings of the Court

1. Covenants Running with the Land. The Court found that because the dollar stores were not parties to the leases containing the grocery exclusive, the exclusive could only be enforced against them if it is a real property covenant running with the land. The Court further found that the exclusive was a real property covenant running with the land under Florida, Georgia, and Alabama law. This included a finding that the dollar stores had actual, constructive, or implied actual notice of the exclusive. Unlike Florida, in Georgia and Alabama a tenant has constructive notice of recorded restrictions from the lease of a co-tenant.

The Court further found that the exclusive was not enforceable in Louisiana because a clearly expressed intention that a covenant run with the land was not enough under Louisiana law to create an enforceable covenant running with the land. The Court also found that the exclusive was not an enforceable covenant running with the land under Mississippi law. In Mississippi, there must be privity of estate between the party seeking to enforce the covenant and the party against whom enforcement is sought and that level of privity was not found to exist between co-tenants of a shopping center.

2. Defining the Terms of the Grocery Exclusive. The grocery exclusive contains two key terms that were crucial to the outcome of this case – “staple or fancy groceries” and “sales area”. In addition, the Court had to construe the terms “10% of the square foot area of any storeroom” and “as an incidental only to the conduct of another business”.

2.1 Grocery items. Winn-Dixie argued that the term “staple or fancy groceries” should be interpreted to include all items listed in the Consumer Expenditure Study published annually by the Progressive Grocer. This definition includes both food and non-food items. The dollar stores argued that this term should be interpreted to include only food items, excluding beverages, snacks, and candy. The Court sided with the dollar stores and found that the term was ambiguous since it was not defined in the leases and can be interpreted in more than one way. The Court also applied the principal that covenants running with the land “must be construed in favor of the free and unrestricted use of property…”[2] Because the term “staple or fancy groceries” is followed by several examples of food items, but no non-food items, the Court found that it applied to food items only. Further, the Court decided that beverages, excluding alcoholic beverages, were “food items” and thus grocery items. This finding is at odds with another Winn-Dixie case in which it was found that grocery items included non-food items.[3] The Court distinguished the *99 Cent* case on the basis that it involved only one lease executed in 1986, while the present case involved over 100 leases dating back to 1957, and that the items sold in grocery stores and supermarkets had evolved between 1957 and 1986.

2.2 Sales Area. Winn-Dixie argued that “sales area” includes both the footprint of the

2 *Sweeney v. Mack*, 625 So.2d 15, 17 (Fla. 5th DCA1993) (citing *NorwoodNorland Homeowners Ass’n v. Dade County*, 511 So.2d 1009, 1014 (Fla. 3d DCA 1987).

3 *Winn-Dixie Stores, Inc. v. 99 Cent Stuff-Trial Plaza, LLC*, 811 So.2d 719 (Fla. 3d DCA 2002).

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display units on which the grocery items were displayed and one half of the adjacent aisle space. The dollar stores countered that the aisle space should not be included. The Court sided with the dollar stores again having to distinguish a contrary ruling in the *99 Cent* case.

2.3 10% of the Square Foot Area of any Storeroom. Similar to the "sales area" determination, the Court found that this term should be interpreted by measuring the area of the storeroom used for sale of grocery items by including the area containing the footprint of the display units only and not any adjacent aisle space.

2.4 As an Incidental Only to the Conduct of another Business. Winn-Dixie argued that the dollar stores' sales of grocery items were not merely "incidental to their business". They contended that the "incidental to their business" limitation is a separate restriction that applies regardless of the size of the area used for the sale of grocery items. The Court rejected these arguments finding (i) this clause not to be an independent restriction but rather coextensive with the clauses referring to the amount of space that could be devoted to the sale of grocery items; and (ii) that the clause is ambiguous and impossible to be practically enforced by injunction.

3. Damages. The Court found that the proposed economic model and regression analysis proposed by Winn-Dixie's expert to prove damages from a breach of the grocery exclusive was not sufficiently reliable. The Court found the proposed proof of damages "not calculable to a reasonable certainty" and "too speculative". Alternative evidence of damages offered by Winn-Dixie was also found by the Court to fail the burden of proof. Thus, Winn-Dixie's damage claim was denied. The Court's chief problem with Winn-Dixie's damages model was that it did not take into account that most of the leases at issue allowed the dollar stores to sell restricted grocery products from a portion of their stores thus making it difficult to isolate actual damages, if any.

4. Injunctive Relief. The Court pointed out that under Florida law, the elements that must be proved to obtain injunctive relief are: (1) a clear legal right; (2) the inadequacy of a remedy at law; and (3) that irreparable injury will occur if such relief is not granted.[4] However, it is not necessary to show irreparable injury to obtain injunctive relief to remedy the violation of a restrictive covenant.[5] Therefore, Winn-Dixie needed to show that it had a clear legal right and that a remedy at law would be inadequate. The Court found that these burdens were met and granted injunctions as to each store found to be in violation of the grocery exclusive after measuring the sales area devoted to grocery items as provided in the opinion.

5. Affirmative Defenses. The Court rejected all of the affirmative defenses raised by the dollar stores. In particular, the Court found that the continuing tort theory applied to the breach of an exclusive use provision so that the statute of limitations had not run. The affirmative defense of laches was denied since laches does not come in to play until the statute of limitations has run unless strong equities favor the application of laches and that burden was found not to have been met. Dollar Tree introduced numerous estoppels that Winn-Dixie had executed advising of no known lease violations. The Court found that Dollar Tree had not relied on these estoppels or other conduct of Winn-Dixie in executing or renewing leases.

4 *Lee County, Florida v. Fort Myers Airways, Inc.*, 688 So.2d 389, 390 (Fla. 2d DCA 1997).
5 *Autozone Stores, Inc. v. Northeast Plaza Venture, LLC*, 934 So.2d 670, 673 (Fla. 2d DCA 2006).

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Next Acts

Winn-Dixie is appealing this decision. According to their lead counsel, they feel that the *99 Cent* case was binding on the Court under *res judicata*. This should have resulted in the Court adopting their positions on the definitions of grocery items and sales area. They also feel the Court erred in its interpretation of Louisiana law on covenants running with the land. Finally, they intend to challenge the Court's rejection of their damages theories.

Lessons Learned

1. Define key terms with as much precision as possible.

1.1 Grocery items. Refer to a definition such as the Consumer Expenditure Study published annually by the Progressive Grocer. Exclude or add non-food items depending on the intent.

1.2 Sales Area. Be clear as to how to measure the affected area including adjacent aisle space.

1.3 Incidental Use. If it is the intent that limited uses in violation of the exclusive will be permitted so long as the primary use of the store in question does not violate the exclusive, be very clear in describing this as a limitation that is separate from the sales area limitations. However, it is likely a very difficult challenge to define this concept with the type of specificity that will pass legal muster for enforcement by injunction.

2. Consider adding specific remedies for breach of the exclusive use.

2.1 This case illustrates just how difficult it is to prove damages resulting from a breach of an exclusive use provision. It is likely that the presence of the dollar stores in the same shopping centers as Winn-Dixie did in fact reduce the sales of Winn-Dixie but clearly measuring the extent of the reduction in sales is very difficult. This difficulty is significantly compounded by allowing limited exceptions to the exclusive for sales in defined limited portions of the stores of co-tenants. As this decision discussed, a loaf of bread purchased in a dollar store will not be bought at the Winn-Dixie store in the same center; but how can you determine whether or not that loaf of bread was purchased from the 500 feet of sales area for grocery items that the dollar store was permitted to have under the exclusive?

2.2 Perhaps, the difficulty of proving damages can be addressed by valid liquidated damages provisions. It is common for exclusive use provisions to provide the tenant with a right to reduce its base rent in a specified percentage if its exclusive is violated. This is an effective remedy against the landlord but what can be done against a breaching co-tenant? Could there be a per day stipulated damages sum? Could this type of liquidated damages provision also "run with the land" and thus be applicable to breaches of the exclusive by co-tenants without privity of contract with the grocery store?

2.3 Consider providing in shopping center leases for liquidated damages in favor of the landlord for breach of an exclusive in the center by a tenant. Consider also giving the landlord the right to assign to the tenant benefitted by the exclusive the landlord's rights against breaching co-tenants.

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A Case Study in the Enforcement ...

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3. Tenant estoppel certificates have a much more limited effect than many practitioners realize.[6] Neither landlords nor tenants should put too much reliance on statements in an estoppel certificate to change the result in disputes concerning lease interpretation issues.

4. Tenants are well advised to perform title searches before they sign leases. There may be restrictions that run with the land and will be enforceable against the tenant and materially interfere with the tenant's business. Based on the cost of the litigation with Winn-Dixie many of the dollar stores have made the business decision to no longer locate in grocery anchored shopping centers. It would be better for a tenant to know of problematic restrictions before making a large investment in a location. ■

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6 "The doctrine of estoppel is grounded in common-law principles of equity. Before any party can claim an "estoppel" against another, that party must be able to prove five things:
(i) lack of knowledge of the facts in question;
(ii) lack of any means of obtaining such knowledge;
(iii) reliance on the words or conduct of the party to be estopped;
(iv) reasonableness and good faith in so relying; and
(v) action, based on such reliance, resulting in a prejudicial change to the party's position.
Because estoppel is an equitable principle, the party seeking its benefit must be innocent and must act in good faith. A party cannot assert estoppel in good faith where it is charged with actual knowledge of the matters in the estoppel certificate. In some jurisdictions, ignorance of the truth of the matter in question is good enough to allow enforcement of an equitable estoppel. Other courts, though, will require the party relying on the estoppel certificate to exercise some degree of due diligence, reasonable care and circumspection in ascertaining the underlying facts. Furthermore, a party put on "inquiry notice" as to the truth of the matter in question or who had the means and opportunity to discern the truth generally cannot assert an estoppel. Similarly, where both parties are equally informed of the matters at hand and have equal avenues of obtaining the necessary knowledge, an estoppel will not be given effect and if the party seeking the estoppel has obtained knowledge which reveals information contrary to that stated in the estoppel certificate, reasonable reliance cannot be established." Herz, *The Use and Misuse of Estoppel Certificates*, E-Dirt Newsletter (Summer 2000).

ACRELades

Thomas C. Barbuti, Douglas M. Bregman, Timothy D.A. Chriss, David S. Cohn, John V. Cogbill III, Raymond J. Diaz, Maureen E. Dwyer, Jeffrey R. Dwyer, Jay A. Epstien, Morton P. Fisher, Jr., David H. Fishman, Joseph M. Fries, Michael D. Goodwin, Robert G. Gottlieb, Jan K. Guben, Nancy Haas, John D. Hagner, Thomas A. Hauser, Philip M. Horowitz, Thomas F. Kaufman, Neil S. Kessler, Frederick L. Klein, David M. Kochanski, Harry W. Lerch, Edward J. Levin, Nancy R. Little, David L. Miller, Searle E. Mitnick, Richard A. Newman, Mark Pollak, Barry P. Rosenthal, Pamela V. Rothenberg, Linda D. Schwartz, Mark S. Shiembob, Kevin L. Shepherd, Lawrence A. Shulman, Charles R. Swartz, Michael H. Terry, James W. Theobald, Raymond G. Truitt, Stefan F. Tucker, William A. Walsh Jr., Keith J. Willner, Roger D. Winston, Fred Wolf III, and James D. Wright were all recognized as Washington/Baltimore's Best Lawyers 2013 edition.

Lawrence A. Shulman was named one of Maryland's top business and civic leaders by the Maryland Chamber of Commerce and inducted into the Maryland Business Hall of Fame.

Joshua Stein was named to the *Super Lawyers* magazine list of Top Ten Attorneys in the New York Metro area, and was listed as one of the ten "most highly regarded" real estate lawyers in the world by the *International Who's Who of Real Estate Lawyers*. ■

The Most Important Issue in Every Ground Lease

by Joshua Stein, Joshua Stein PLLC, New York, NY[1]

Whenever a property owner negotiates a long-term ground lease of a development site, one issue overwhelms almost all others: how should ground rent adjust over time to protect the property owner, as landlord, from inflation and the ever-declining value of the dollar?

Typically, the parties resolve this issue by saying that every two or three decades, they will reappraise the development site that the landlord originally delivered to the transaction. The ground rent will become 6 or 7% of the then-current fair market value of the site. Until that happens, rent usually goes up a bit every year or every few years. And, in most cases, the rent can never drop.

The reference to 6 or 7% in rent adjustment formulas has remained remarkably stable over a very long time, including in the last few years of very low interest rates.

Although ground leases often use the "typical" approach just described, tenants worry that if a rent adjustment occurs in a low interest rate period, such as the present, this approach may overcompensate the landlord – producing excessive ground rent and diminishing or even destroying the value of the tenant's leasehold estate. Leasehold lenders, usually even more conservative than developers and investors, will fear that an uncontrollable and massive increase in ground rent at some far-off future date will diminish or destroy the security for their loans. Even if developer tenants sometimes behave like "cowboys" and take risks, lenders usually do not. And the obligation to pay ground rent is always structurally senior to any leasehold lender's collateral.

The "typical" approach to ground rent adjustments, as described above, will create problems for the tenant if, at the moment of the rent reset, valuations in the larger real estate market use capitalization rates significantly below 6%. Sometimes ground leases seek to mitigate these risks by replacing a fixed percentage (again, typically 6 or 7%) with a percentage tied to long-term interest rates at the time of the rent reset. A ground lease could also conceivably, though not in the real world, refer to some objective third-party index for long-term capitalization rates for real estate investments at the time of the rent reset.

Of course, if a traditional rent reset occurs in a real estate depression – or at a time when, for whatever reason, valuations use very high capitalization rates -- the tenant may get lucky.

It is sometimes suggested 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 five-year period whose midpoint is the intended rent reset date. That approach may have some logic to it. For example, suppose a rent reset used a single fixed valuation date of October 1, 2009. Given the state of the financial world on that date, the landlord would probably feel victimized by a very low valuation. And, going forward, that particular landlord might thereafter favor the use of multiple dates over an extended time. Even so, landlords and tenants generally prefer to avoid the time, expense, and issues of dealing with, e.g., five appraisal dates instead of just one. They feel that way even though it might remove some of the arbitrariness of the

1 A much shorter version of this article appeared in the [New York] *Commercial Observer*, June 2012 supplement on mortgage financing, at page 16. A more extensive version will appear in *The Practical Real Estate Lawyer*.

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calculation. The use of a single bright-line date introduces a greater element of luck for both parties, but they seem willing to live with that.

Experience has shown that the need to periodically revalue the site invites disputes, because landlord and tenant will for obvious reasons have dramatically different views of the value of the land, or what the appraisers should appraise and how, particularly as markets and other circumstances change.

One common disagreement relates to whether the appraisers should appraise raw land, or should include improvements – either whatever improvements existed on the site when the parties signed their lease, or whatever improvements exist at the time of the revaluation. In general, the appraiser should try to replicate whatever existed when the parties signed the lease – usually, vacant land. And the lease should say that.

If improvements existed at lease inception, then the appraiser should usually consider them as they existed at that time, if at all. A lease might require the appraisers to take into account any upgrading or expansion that the tenant accomplished. This would, in effect, require the tenant to pay, through rent, for value that the tenant and not the landlord created or provided. That is not "fair," as it would effectively force the tenant to pay twice for whatever work the tenant did -- once when doing the work, a second time by paying rent based on the completed work. The lease language should resolve that question, one way or the other, and not leave it to appraisers, courts, or arbitrators.

Any ground lease negotiator will also need to think about possible future disconnects between the development potential of hypothetical raw land and the actual physical development that exists on the site. For example, changes in zoning or others laws could change the value of hypothetical raw land. For purposes of the ground lease, though, the parties need to think about one minor detail: if the transaction played out as the parties anticipated, the tenant has already built improvements on the land that will very likely not be obsolete – ready for demolition -- at the time of the rent reset. If zoning at the time of the rent reset would allow much more development than the building in place, that does not help the tenant very much. If the tenant must pay rent for development potential that, as a practical matter, the tenant cannot use, the tenant's leasehold may become uneconomic. What if zoning at the time of rent adjustment allows much less construction than already exists on the site? Should newly discovered environmental issues affect the land value? And what if the local government decides to issue a landmark designation for the existing improvements?

Landlords and tenants can also fight over whether any appraisal of the land (or of whatever) should "consider the terms of the lease." The inquiry seems circular, as the value of the landlord's land will depend in large part on the amount of the rent revenue, so it makes no sense to determine the rent revenue based on the value of the landlord's land. One can resolve the circularity by deciding that the parties really meant something a little different. Specifically, they probably meant that any valuation should take into account any lease terms that limit permitted uses or, perhaps, that limit other rights of the tenant.

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 tenant can use the site only to construct a "car wash with ancillary coffee shop," regardless of what the law might allow, then that limited range of uses – if applied to the land value as part of the

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appraisal process -- will drive down the value of the land. That is probably what a lease means when it requires the appraisers to "consider the terms of the lease." And it makes sense because if the lease only allows the tenant to construct a car wash with an ancillary shoe repair shop, the tenant should not pay rent for the right to build a 50-story office building, even if zoning law would allow it.

Differences of opinion on these and similar issues translate directly to dollars, lots of them, over a very extended time.

The "standard formula" described above – 6 or 7% of land value -- will never precisely correlate with what the adjusted rent "should be" under some "fair" view of the world. It's a crapshoot. But landlords and tenants often still take their chances, recognizing that either party may face surprises, but also "this is the way everyone does it," and lenders have underwritten and financed similar leaseholds for decades.

Landlords and tenants do sometimes try to find a "better way" to handle rent adjustments. They often start by suggesting that the rent should, at least in part, reflect the tenant's revenues. The landlord could receive some percentage of "gross revenues," perhaps after modest deductions.

It sounds reasonable. But what if the tenant does not try very hard to rent the space? Or occupies the space itself to conduct business? Or leases the space to a chain store at below-market rents while simultaneously entering into an above-market lease with the same tenant in another state? Or does not invest the capital necessary to achieve the highest rents? And what should the lease allow the tenant to deduct, e.g., leasing costs or capital expenditures necessary to attract space tenants? And how can the landlord know the tenant is not lying or artificially reducing its revenues? Before long, the exercise reinvents the Internal Revenue Code.

If a landlord and a tenant do decide to go down that road, then they (particularly the landlord) should take a few measures to prevent disputes. First, keep it dumb and simple, without a lot of fine lines, exclusions, and characterizations – each providing fertile ground for misunderstandings, strategizing, and disputes. Second, give the landlord a low percentage of a broad variable without too many deductions. Third, paint with a broad brush. And think about all the possible circumstances that might occur and how they 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 makes sense.

Any contingent rent formula in a ground lease might also award the landlord a percentage of capital transactions – lease assignments, refinancings, or other transactions tantamount to either. Here too the principles above will apply. And, again, any uncertainty about line drawing or inclusions or exclusions will breed future disputes. For example, does a "refinancing" include the circumstance where the tenant 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?

Setting aside the many opportunities for dispute inherent in any contingent rent, even a very low percentage of the tenant's "gross" can place a very significant burden on the tenant, and give the landlord a correspondingly significant stream of contingent rent. For example, suppose the tenant agrees to pay the landlord 3% of gross revenue – a really small percentage. Assume the tenant's operating expenses,

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real estate taxes, and insurance consume 50% of gross revenue. Assume ground rent consumes another 10% and debt service another 20%. These numbers come out of a hat, but a reasonably realistic hat.

After those deductions, the tenant really gets to "keep" only 20% of the gross revenue. The landlord's 3% share of that gross revenue represents almost one-sixth of the tenant's bottom line. So a really small percentage turns out to loom rather large. Assuming the tenant will consider the concept at all, one might expect the tenant to respond in part by trying to credit one ground stream against another ground rent stream, but that discussion lies outside this article.

If the parties do not want to agree to contingent ground rent, how else can the parties protect the landlord from inflation and equitably compensate the landlord, while protecting the tenant from the destruction of its leasehold through an unaffordable rent increase?

One could tie periodic major rent adjustments to an index – as the most obvious candidate, the consumer price index. People in real estate, in particular lenders, usually think the CPI goes up faster than real estate values and rents. And if the parties "cap" any periodic rent adjustment, then the landlord will not achieve its goal of protecting itself from inflation.

Perhaps the parties can find an index better than CPI, such as Class A office rents, average daily rate for hotel rooms in a certain market stratum, real estate tax assessments, or retail rents, always for some defined local geographical area. Future changes in this index would drive changes in the ground rent, regardless of what this particular tenant does or earns in the space. Such an index, or perhaps a combination of multiple indexes, could make sense, especially if it matched likely uses of the site.

Ground leases once required tenants to pay rent equal to the dollar equivalent of a certain amount of gold. The federal government outlawed that in the 1930s as part of President Roosevelt's plan to save the economy. Gold clauses became legal again in 1973. They certainly protect landlords from the declining value of the dollar. In the last few decades, gold clauses would have produced dramatic rent increases given the ever-increasing dollar value of gold (the plummeting value of the dollar). But tenants would fear a disconnect between the price of gold and the "right" rent, in dollars, for this particular site. During the last few decades, any such fear would have been entirely justified. And, looking forward, a landlord may feel gold has run its course, so a gold clause may not accurately reflect the future value of this particular site. And a landlord may care more about the value of this particular site than about the general value of the dollar.

As another approach, the parties could try to devise a rent adjustment scheme to try to assure that, over time, landlord and tenant 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 landlord's and the tenant's position, taking into account the adjustment. Then the ground lease would also add a requirement – and potentially a further rent adjustment to assure -- that at the end of the day each party would maintain the same percentage of the value of the project as a whole.

For example, if the initial ground rent were calibrated to give the landlord a position worth 34% of the project as a whole, then any future ground rent would need to be calibrated to give the landlord a position worth 34% of the project as a whole, taking into account market

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conditions at the time of the 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 pockets of the other party.

Although this approach has a theoretical appeal to it, it is very much not market standard. And it becomes complicated as soon as one thinks about additional capital investment the tenant will make in the project, to upgrade it and increase its value, or even just to keep it functional and rentable. How does one slice up any increases in value, of the project as a whole, that result from the tenant's investment and brilliant development, leasing, and management strategies? Those issues seem particularly troublesome where the lease demises a vacant site, and perhaps less troublesome for an existing building. The "recalibration" mechanism also needs to recognize that over time the value of the leasehold is "supposed to" go down, because of the ever-decreasing duration of the remaining term of the ground lease.

Though complicated, these issues may not exceed the negotiation and drafting capacities of smart real estate investors and their lawyers. The author's many recent experiences as an expert witness suggest, however, that the commercial real estate industry and the lawyers who serve that industry categorically overestimate their smartness and ability to "get everything right."

Ground lease negotiators might eventually hedge some risks of real estate inflation and ground rent adjustments through insurance or real estate futures markets – 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 may be safe to assume that new derivative products are not at the top of anyone's list. Great financial minds may bridge part of that gap such as by "insuring" against inflation through puts and calls involving long-term TIPS bonds. But that too has its costs and risks.

Lease negotiators typically worry that creative structures like those proposed in this article will not work right because of some problem or gap no one notices until the litigation begins. It is a reasonable form of free-floating anxiety when trying to create something "new and different" that will work right for 99 years. That fear of change, coupled with the need to satisfy future lenders, will often drive ground lease negotiators back to the traditional rent adjustment formula described in the first part of this article. ■

In Memoriam

The College notes with sadness
the passing of

John E. Blyth, Pittsford, NY
William A. Chatterton, Madison, WI
Patrick A. Randolph, Jr., Kansas City, MO
Gary A. Taback, West Bloomfield, MI
Stanley A. Williams, Cleveland, OH