

# VALUATION CLAUSES IN LEASES, GROUND LEASES AND PURCHASE OPTIONS

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Long term leases, ground leases and purchase options often require valuation of property to re-set rent or establish a purchase price. In theory this is a good method for assuring the rent or option price stays

“at market” over a long period of time. In practice however, unclear or poorly drafted leases can lead to lengthy, expensive valuation processes that may yield unpredictable results. Analyzing a lease with one of these valuation clauses requires understanding whether the lease document defines a clear process that will lead to a predictable result.

## METHODS FOR REVALUATION

Various methods are used to determine the current value of property. Some leases have fixed increases specified adding predictability, but not necessarily keep pace with changes in the marketplace. Others use indices like CPI, or price changes of other assets like gold as a proxy for changes in property value.

Often leases use a valuation clause, where current value is determined by appraisers or arbitrators. This method adds human judgment to the process, and if properly structured, it can provide an accurate way for rent or property value to keep pace with the marketplace. If poorly structured however, the results can be far from the intent of the original parties to the lease.

## CONSIDERATIONS FOR ESTABLISHING A SUCCESSFUL PROTOCOL

When an appraisal or arbitration process is used, clarification of key issues can avoid disputes over the original intent of the lease. Below are some issues to be considered:

- What is to be valued: land, or land and build-

ings?

- Should a Market Rent estimate include market lease terms, concessions and escalations in addition to the rental amount?
- Should land be valued:
  - a. As though vacant, without regard to the improvements?
  - b. Subject to the existing improvements (residual)?
  - c. Less the cost of clearing the existing improvements?
  - d. As is, less the improvements (i.e. - a hole in the ground where the garage used to be)?
- Should improved property be valued:
  - a. As built?
  - b. In shell condition?
  - c. In shell condition less the cost of removing existing improvements?
- What premise of property use should be considered:
  - a. Existing use?
  - b. Highest and Best Use?
  - c. A prior use?
  - d. A previously allowed use?
  - e. A restricted use according to a use restriction in the lease?
  - f. The Leased Fee interest as encumbered by the existing lease?

Arbitrators taking different approaches on any of these issues could lead to significantly different analyses and unpredictable conclusions; thus, increasing the risk of the asset.

## MAKING THE DECISION

Value decisions are often made by either one mutually agreed-upon arbitrator, or by a panel of three arbitrators. In the latter case, each side typically picks one arbitrator, and the two selected arbitrators

pick the third. The lease should specify how the decision will then be made. Some options include: averaging the three opinions; averaging the two closest together; using the opinion of the third arbitrator; Day Baseball Arbitration where the neutral third picks one opinion or the other; Night Baseball Arbitration where the neutral does not see the other opinions but makes his/her own opinion and the award is that of the party-appointed opinion closest to the neutral; two out of three must agree; all three must agree; or occasionally the document is silent on the decision process leaving it up to the parties to decide how the decision will be made each time the value is to be re-set.

## SELECTING THE ARBITRATOR(S)

A lease will often state the required credentials of an arbitrator. It may require that the arbitrator be an appraiser, but sometimes it allows the arbitrator to be a broker, an attorney or a retired judge. Arbitrators may be required to have certain credentials such as: an MAI designation, an MAI or its equivalent, a state appraisal license, or X years of experience in the local market area or with a particular property type. Disclosure of conflicts is part of the selection process as required by the CCP.<sup>1</sup>

## COMMUNICATION BETWEEN THE ARBITRATORS

Rules are often established regarding communication between the arbitrators. Some leases mandate no communication between party-appointed arbitrators. Others require communication in a specified manner such as: a “meet and confer” between the arbitrators regarding the market data used, or the opinions of value.

A formal hearing is required in some leases. The lease should be clear regarding who attends and who presents at the hearing from among the arbitrators, the parties, their counsel and outside witnesses. Additional

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rules governing hearing protocol are found in the CCP<sup>2</sup>.

### PARAMETERS FOR THE VALUATION

Leases may require that certain approaches to value (Sales Comparison, Income Capitalization, Residual, etc.) are used or not used. They may also define parameters for market data that may or may not be considered, such as: data within a specified market area, date range or size range; data from

properties owned or controlled by one of the parties; or data from prior arbitration awards. The final written decision may state only the valuation or it may include the reasoning behind the conclusion.

### CHALLENGING THE AWARD

The lease may state whether the award can be challenged by either of the parties. If the lease does not make provisions for challenging the award, then potential challenges are governed by the CCP<sup>3</sup>.

California case law provides that parties may not seek to impose civil liability on, or seek to recover damages from the arbitrator or arbitration organization because the arbitrator and arbitration organization enjoy the benefit of absolute judicial immunity as applied under the common law to arbitrators.<sup>4</sup>

### CONCLUSION

Properties encumbered by long term leases, ground leases or purchase options with valuation clauses have unique characteristics that should be carefully analyzed to fully understand the risk of the asset. Well written valuation clauses can make for a predictable re-setting of the rent or purchase price. Valuation clauses that are vague or ambiguous in the

areas noted above can lead to unpredictability in future cash flows and thus increased risk. Taking these factors into consideration will enhance underwriting and lead to sound loan transactions.



1. *California Code of Civil Procedure, Section 1281.9.*
2. *California Code of Civil Procedure, Sections 1282.2(d) and 1282.4(a).*
3. *California Code of Civil Procedure, Sections 1285-1287.6.*
4. *La Serena Properties, LLC v. Weisbach, 186 Cal. App.4th 893 (2010), and Statz v. Charles R. Schwab, 121 Cal.App.4th 420 (2004).*