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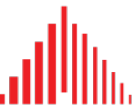


The Role of Appraisers in Ground Lease Revaluation Provisions

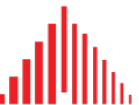
Gary S. DeWeese, MAI

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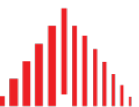
- **Founder of Real Estate Strategic Solutions, LLC, a real estate consulting firm. Practice focuses on complex and unusual assignments, including public-private ground lease development, transaction negotiation, property tax appeals, arbitration and litigation support.**
- **Former Assistant Treasurer-Real Estate and Director of Real Estate Investments for the University of California System's pension and endowment funds (one of the 15th largest such institutional investors in the US), where he was the senior management executive responsible for both publicly traded and private direct real estate investments and head of the corporate real estate group.**
- **MBA from the University of California, Berkeley where he has also guest lectured. He is a member of and an instructor for the Appraisal Institute (MAI designation), authored numerous articles for The Appraisal Journal, and spoken at numerous conferences worldwide.**
- **Contact information: 925-216-8751 or garydeweese@comcast.net. Web: www.garydeweese.com and www.restrategicsolutions.com.**



- **Ed is a trial lawyer and the Chair of the Litigation Department at Cox Castle & Nicholson LLP with offices in Orange County, Los Angeles and San Francisco. He is experienced in a broad range of complex commercial disputes including valuation disputes, construction claims, partnership/corporate governance disputes, fraud & breach of fiduciary duty claims, lease disputes, unfair business practice claims, insurance coverage litigation (CGL, Property, E&O and D&O policies), breach of contract and easement disputes, and non-disclosure claims. Ed's experience extends into state court, federal court, private arbitration and public works arbitration at the trial court and appellate levels. He represents property owners, developers, lending institutions, investors, lessees and others involved in the real estate industry.**
- **For valuation disputes involving real estate, the legal issues underlying the valuation can be the central issue that drives increases or decreases in ultimate value.**

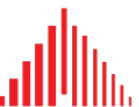


- Ed has tried countless valuation disputes, including those involving office buildings, hotels, regional shopping centers, residential developments, parking facilities, industrial projects, multi-phased mixed use commercial projects, resort developments, vacant land, prison facilities, manufacturing facilities and more. Critical issues that can have a significant impact on valuation include the permissible uses to be considered in setting value, the consideration of existing improvements, the impact of lease and other contractual restrictions on valuation, the relevance and impact of changes in zoning and other applicable laws, current feasibility analysis, encumbrances on property, etc.
- JD from University of California at Berkeley and undergraduate degree from UCLA in economics and business.
- Contact information: (310) 284-2271 or equigley@coxcastle.com



Outline of today's presentation

- 1. Purpose of a land revaluation or rent re-set provisions**
- 2. The various roles that appraisers may have**
- 3. What is to be determined by the appraiser?**
- 4. What is the basis of the appraiser's revaluation (highest and best use or something else)?**
- 5. If time, special provisions in a ground lease that could impact the determination of the land value or land rent**

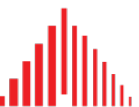


Basic Ground Lease Structure

Landowner = landlord under
ground lease (leased fee)

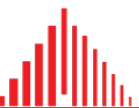
Developer = tenant under the
ground lease and landlord under
space leases to subtenants of the
building (leasehold and in
sandwich position)

Tenants under the
space leases in the
building
(subleasehold)

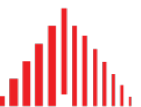


Purpose of the Revaluation Provision

- 1. Adjusts the contract rent periodically so that it matches market rent.**
- 2. Effectively eliminates some or all of any rent advantage that a tenant may have over the longer term, thus reducing the potential for the tenant to achieve any meaningful positive leasehold value.**
- 3. May result in creating a negative leasehold value if the revaluation provision contains a provision that the contract rent at the time of rent reset will be the greater of the market rent or the contract rent then being paid. In other words, the contract rent cannot be decreased below the level of the most recent year – even if market rents have declined the “higher than market” contract rent would remain unchanged and value of leasehold would be negative.**



- 1. Landlord and tenant mutually select the appraiser**
 - a. if the parties cannot agree on the selection, then each party names an appraiser or another person with those 2 appraisers or persons selecting the appraiser.**
 - b. If the parties cannot agree, then a 3rd party neutral (e.g., judge) selects the appraiser.**
 - c. Rent or land value decision of the selected appraiser is final unless both parties reject the appraiser's decision.**
- 2. Landlord and tenant each select their own appraiser (see next slide)**

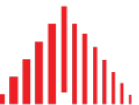


2. Landlord and tenant each select their own appraiser

- a. If the difference is less than x%, then the 2 opinions are averaged.
- b. If the difference is greater than x%, then the first 2 appraisers appoint a 3rd appraiser.

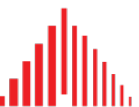
The 3rd appraiser may be instructed to:

- Serve initially as mediator to resolve differences
- Decide which one opinion most closely reflects the market (baseball arbitration).
- Develop an independent opinion, which is (i) binding on the parties, (ii) averaged with the prior opinions, (iii) averaged with the next closest one; or, (iv) rejected if outside the range of the first 2 opinions, which are then averaged. The 3rd appraiser may be restricted to using only the data used by the first 2 appraisers.
- Participate in a 3 person joint appraisal with the original 2 appraisers with the outcome being determined by the majority.
- Hear testimony of the original 2 appraisers and make the decision.
- Some other task?



What is usually to be determined by the appraiser in a revaluation provision?

1. Land rent
2. Land value that is multiplied by % (land capitalization rate) specified in the lease.
3. Land value that is multiplied by land capitalization rate determined by the appraiser.



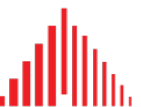
Basis of the appraiser's revaluation is usually its highest and best use, but what is the highest and best use?

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Often, the ground lease is not clear or is vague

- 1. The same use as of the commencement of the ground lease?**
- 2. The actual use as of the revaluation date?**
- 3. Subject to the then depreciated value of the improvements in place?**
- 4. An alternative highest and best use as of the revaluation date (of the same or different size of the then improvements in place)?**
- 5. Alternatives 1 – 4 subject to the terms of the ground lease (including or not including the remaining duration) or without regard to the terms of the ground lease?**
- 6. Other combinations or permutations of the above may be possible.**

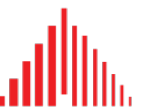
What if the parties do not agree as to what the ground lease says? See next slide.



What if appraiser's role is unclear or the parties do not agree on the basis of the revaluation?

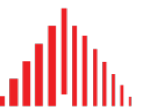
- 1. 3rd party appraiser/arbitrator engagement is often the result of the parties (and their respective advisors/appraisers) having never agreed originally on the basis of the future revaluation.**
- 2. If that is the case, then the parties will need to stipulate as to the basis of the revaluation, with help of their legal representatives and the appraiser(s), prior to the current appraiser/arbitrator engagement.**

Note. Refer to Guide Note 16. Arbitration regarding the role of appraisers in arbitrations.



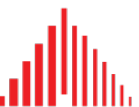
1. Subordination or Non-subordination of landlord's interest in a ground lease to any tenant financing.

- a. Most modern ground leases contain a non-subordination provision b/c the land owner does not want to risk losing the land in the event of a foreclosure on a tenant's loan(s).**
- b. Most, but not all, lenders will agree to a "non-subordination" provision provided the lender has certain "cure" rights in the event of a tenant default (e.g., to pay the ground rent) and, further, has the right to "step into the shoes" of the tenant with the landlord being required to accept the lender as the new tenant. The lack of a "non-subordination" provision would likely lower the value of the land for revaluation purposes if the valuation is subject to the terms of the ground lease.**



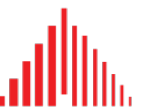
2. Demolition obligation at the end of the ground lease.

- a. Does the Landlord have the option of electing demolition of the existing improvements at the tenant's expense?
- b. If not, and the landlord is responsible for demolition at the landlord's expense, then the reversion of the land to the landlord at the end of the lease will need to account for the possible future cost of demolition. This future obligation could also diminish the value of the land for revaluation purposes during the term of the ground lease if the valuation is subject to the terms of the ground lease.
- c. Even if demolition is the tenant's responsibility, does the lease provide a basis for assuring that the demolition funds will actually be in place (e.g., is there a demolition reserve account prefunded by the tenant say during the last 10 years of the ground lease)?



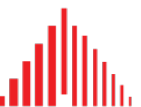
3. Replacement Reserve Account for Short-Lived Items that wear out before the ground lease expires

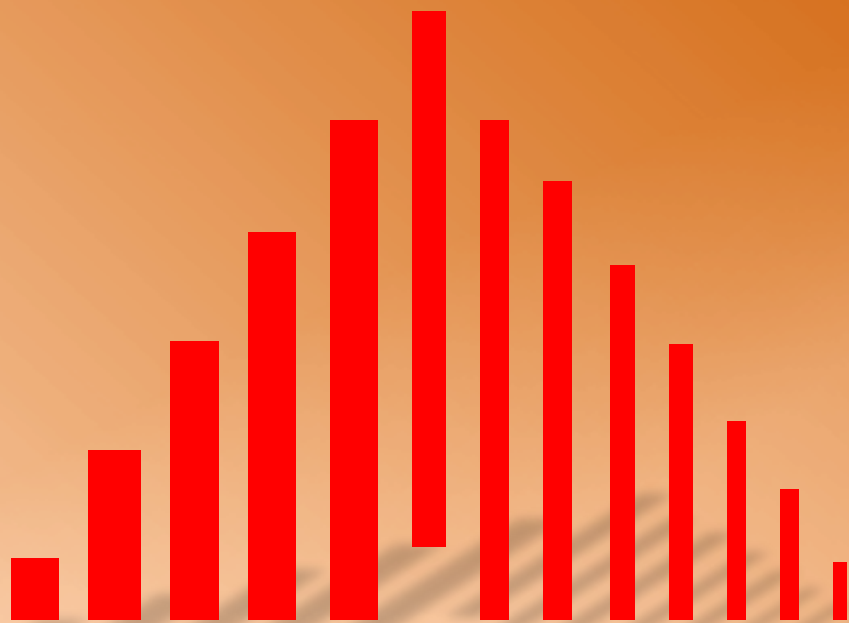
- a.** Is the Tenant obligated to periodically replace building components in order to maintain the property's competitive position in the marketplace and preserve the reversion?
- b.** If not, then the periodic land revaluation could be negatively affected if such revaluation is subject to the improvements in place.
- c.** Even if the tenant is obligated to replace building components, is the Tenant required to set aside reserves to secure the obligation? If there is no provision for reserves to be set aside, then the tenant's predilection is to let the improvements go to waste as the lease expiration nears, which could affect a land revaluation prior to expiration of the lease?



- 4. Property tax increases on the land that cannot be passed onto the tenant.**
 - a. If the Tenant is only obligated to pay property tax increases permitted by statute based on no change in ownership, and the Landlord's leased fee interest is sold during the lease term, then the Landlord will have to pay any increase above the statutory amount, thus negatively affecting the value of the land for revaluation purposes.**

Note to attendees: A lease with a rent revaluation provision poses interesting issues for the appraiser valuing a leasehold, which is not the purpose of this presentation. This topic is more thoroughly covered in the Appraisal Institute's seminar entitled "Evaluating Commercial Leases – The Terms and the Tenant Both Matter".





Thank You