NYSBA

Commercial Real Estate Leases 2018

October 10, 2018
New York City

October 23, 2018
Buffalo

7.5 MCLE Credits in Professional Practice

Sponsored by the Real Property Law Section and the Committee on Continuing Legal Education of the New York State Bar Association

This program is offered for educational purposes.

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Program Description

The New York State Bar Association is pleased to present this advanced seminar covering cutting-edge topics related to commercial real estate leasing in New York State. Featured panelists include leading law firm and in-house lawyers, brokers and other professionals involved on the front lines of leasing in one of the most challenging economic climates in decades. Their insight will impart valuable perspective on where the market has moved and where the market is going for lease transactions of all sizes and types. The program is designed to impart insight on current market practices as well as explore how the challenges of the economic crisis have shifted or transformed many fundamental aspects of leasing transactions. The program will also cover the current state of insurance provisions in leases, as well as the latest trends in brokerage agreements. Finally, the program will survey options and emerging trends in enforcement of leases and alternative remedies.

Commercial Real Estate Leases CLE program

Wednesday, October 10, 2018 | NYC
Tuesday, October 23, 2018 | Buffalo

NYC PROGRAM AGENDA

7.5 MCLE Credits; 7.5 Areas of Professional Practice

8:30 a.m. – 9:00 a.m.	Registration
9:00 a.m. – 9:10 a.m.	Introductory Remarks
9:10 a.m. – 10:25 a.m.	**Alternate Dispute Resolution Procedures and Provisions in Commercial Leases** *(1.5 MCLE credits; 1.5 areas of professional practice)*
10:25 a.m. – 11:15 a.m.	**Work Letters or What Leasing Lawyers Need to Know About Design and Construction Agreements** *(1.0 MCLE credits; 1.0 areas of professional practice)*
11:15 a.m. – 11:25 a.m.	Break
11:25 a.m. – 12:15 p.m.	**Economics of the Deal** *(1.0 MCLE credits; 1.0 areas of professional practice)*
12:15 p.m. – 1:15 p.m.	Lunch Break
1:15 p.m. - 2:05 p.m.	**Omni-Channel Leasing** *(1.0 MCLE credits; 1.0 areas of professional practice)*
2:05 p.m. – 2:55 p.m.	**Representing the Not-For-Profit Entity in Leasing** *(1.0 MCLE credits; 1.0 areas of professional practice)*
2:55 p.m. – 3:10 p.m.	Break
3:10 p.m. - 4:00 p.m.	**Letters of Credit and Guarantees** *(1.0 MCLE credits; 1.0 areas of professional practice)*

4:00 p.m. – 4:50 p.m.	**Tax Issues in Commercial Leasing** *(1.0 credits; 1.0 areas of professional practice)*
4:50 p.m. – 5:00 p.m.	Question & Answer Session
5:00 p.m.	Adjournment

Accessing the Online Course Materials

Below is the link to the online course materials. These program materials are up-to-date and include supplemental materials that were not included in your course book.

www.nysba.org/CommercialRealEstate18/

All program materials are being distributed online, allowing you more flexibility in storing this information and allowing you to copy and paste relevant portions of the materials for specific use in your practice. WiFi access is available at this location however, we cannot guarantee connection speeds. This CLE Coursebook contains materials submitted prior to the program. Supplemental materials will be added to the online course materials link.

New York Rules of Professional Conduct

These Rules of Professional Conduct were promulgated as Joint Rules of the Appellate Divisions of the Supreme Court, effective April 1, 2009, and amended on several occasions thereafter. They supersede the former part 1200 (Disciplinary Rules of the Code of Professional Responsibility).

The New York State Bar Association has issued a Preamble, Scope and Comments to accompany these Rules. They are not enacted with this Part, and where a conflict exists between a Rule and the Preamble, Scope or a Comment, the Rule controls.

This unofficial compilation of the Rules provided for informational purposes only. The official version of Part 1200 is published by the New York State Department of State. An unofficial on-line version is available at www.dos.ny.gov/info/nycrr.html (Title 22 [Judiciary]; Subtitle B Courts; Chapter IV Supreme Court; Subchapter E All Departments; Part 1200 Rules of Professional Conduct; § 1200.0 Rules of Professional Conduct).

http://nycourts.gov/rules/jointappellate/NY-Rules-Prof-Conduct-1200.pdf

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Commercial Real Estate Leases 2018
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Topic I

Alternate Dispute Resolution Procedures and Provisions in Commercial Leases
By

Janice Mac Avoy, Esq., Danielle C. Lesser, Esq., and Joshua Stein, Esq.

Litigation Considerations in Leasing: Arbitration vs. Litigation

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I. ARBITRATION VS. LITIGATION

A. Advantages and disadvantages of arbitration: Arbitration can be quicker than a plenary action in Supreme Court – arbitration has limited, more streamlined discovery (or no discovery if lease so provides), but may take longer than a summary proceeding in Civil Court. Arbitrators can be selected based on specialized knowledge or can be pre-selected in the lease itself.

1. Carefully consider the qualifications of the arbitrator and whether there will be qualified arbitrators available.

2. Consider whether some or all disputes will be arbitrated:

   (a) Just FMV resets?

   (b) All disputes?

B. Will you be better served by imposing the higher costs of litigation on the other side?

C. Consider the tendency of arbitrators to "split the baby." This can be minimized by using a baseball provision -- where the arbitrator selects only one party's determination, whichever is closer to correct.

D. Certain types of disputes are better suited to submission to arbitration before arbitrators with specialized knowledge, such as fair market rent re-sets, where arbitrators are typically appraisers with specialized knowledge of market value, or construction disputes that arise during major tenant improvement construction work, which must be decided quickly and benefit from an arbitrator with construction-related expertise.

1. For matters that will only arise in the initial stages of the lease, such as disputes over construction or tenant build-outs, considerthat pre-selecting arbitrators can quickly rule.

2. Consult with a litigator before setting pre-determined time periods for an expedited arbitration. While certain disputes must be resolved quickly, you want to provide time for your litigators to be able to

adequately prepare their case.

E. Arbitration clauses typically provide for either a single arbitrator or a panel of three arbitrators. If a panel of three is chosen, the lease should specify that:

1. Party-appointed arbitrators are non-neutral, and each party may have *ex parte* communications with their party-appointed arbitrator.

2. The role of party-appointed arbitrators – whether they can cross-examine witnesses, provide testimony, what is their role in deliberations?

3. Baseball arbitration (arbitrator may select only landlord <u>or</u> tenant's determination, may not make his/her own determination) vs. majority decision vs. unanimous decision: baseball arbitration keeps the parties honest and will require them to make a reasonable submission to the arbitrators, making settlement more likely. Requiring a unanimous decision creates the possibility of deadlock, whereas a simple majority decision creates the possibility that the arbitrators will "split the baby" – a common complaint about arbitration.

4. Consider the cost and effectiveness of a panel of three versus the unpredictability of a single arbitrator.

F. The arbitration clause may provide expressly whether a court or the arbitrator should decide threshold questions of arbitrability in the first instance. In the absence of such an express provisions, the courts will presume that the parties intended for the court to decide the threshold question of whether or not the dispute is arbitrable. *First Options of Chi v. Kaplan*, 514 U.S. 938, 943 (1995). However, if the arbitration clause provides that AAA rules apply, the arbitrator will decide the question of arbitrability in the first instance, pursuant to AAA rules. *See* AAA Commercial Arbitration Rules, R-7(a) (effective Oct. 1, 2013) ("The arbitrator shall have the power to rule on his or her own jurisdiction, including any objections with respect to the existence, scope or validity of the arbitration agreement or to the arbitrability of any claim or counterclaim."). Thus, by incorporating the AAA Arbitration Rules, the Parties agreed to delegate any questions of arbitrability to the arbitral tribunal. *See Life Receivables Tr. v. Goshawk Syndicate 102 at Lloyd's*, 66 A.D.3d 495, 495-96 (1st Dep't 2009) ("Although the question of arbitrability is generally an issue for judicial determination, when the parties' agreement specifically incorporates by reference the AAA rules, which provide that '[t]he tribunal shall have the power to rule on its own jurisdiction, including any objections with respect to the existence, scope or validity of the arbitration agreement,' and employs language referring 'all disputes' to arbitration, courts will 'leave the question of arbitrability to the arbitrators….'") (citation omitted), *aff'd*, 14 N.Y.3d 850 (2010).

G. If there is a challenge to the validity of the arbitration clause itself, however, that challenge must be decided by a court, not the arbitrator. *Matter of Teleserve Sys., Inc. (MCI Telecommuns. Corp.)*, 230 A.D.2d 585, 592-93, 659, N.Y.S.2d 659, 664 (4th Dep't 1997). But "courts look only to whether the arbitration clause itself was induced by fraud or duress; the question of whether the overall agreement is invalid is for the arbitrators" to decide. *Zurich Ins. Co. v. R. Elec., Inc.*, 5 A.D.3d 338, 339, 773 N.Y.S.2d 560, 560 (1st Dep't 2004). If a court concludes, however, that "the alleged fraud was part of a grand scheme that permeated the entire contract, including the arbitration provision, the arbitration provision should fall with the rest of the contract." *Weinrott v. Carp*, 32 N.Y.2d 190, 197, 344 N.Y.S.2d 848, 855(1973).

H. Under New York law, an arbitration award is conclusive and binding on the parties absent fraud, illegality or undisclosed bias. The parties may not challenge the arbitration award simply on the basis that the arbitrator wrongly decided the law or the facts. See *DigiTelCom v. Telez Sverige*, 2012 WL 3065345 (S.D.N.Y. July 25, 2012) (sanctioning law firm for frivolous challenge to arbitration award: "Plaintiff's challenge to the Award amounts to little more than an [improper] assault on the Tribunal's fact finding and contratual interpretation rather than on its actual authority"). *But see LJL 33rd Street Associates, LLC v. Pit Cairn Properties, Inc.*, 11 Civ. 6399 (JSR) (S.D.N.Y. Feb. 15, 2012) (arbitrator's valuation overturned for improperly excluding evidence relating to the fair market value of the property). In addition, courts have set aside arbitration awards when the arbitrator exceeded his or her authority. *N.Y. by Off. of Mun. Labor Rel. v. Davis*, 146 A.D.2d 480, 482-83 (1st Dep't 1989) (finding that the arbitrator violated a provision in the agreement that he "shall not add to, subtract from or modify any contract" when he cited nonexistent provisions and relied on matters outside of the agreement).

I. Consider that arbitration is private and confidential vs. a case filed in court, where all papers filed are publicly available.

THE MOST IMPORTANT ISSUE IN EVERY GROUND LEASE

RENT RESETS AND REDETERMINATIONS, FAIR MARKET AND OTHERWISE

Joshua Stein[1]

When a Landlord and a developer (Tenant) 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 Landlord from inflation? And how can Landlord participate in future increases in value of the property, which may or may not correlate with inflation? At the same time, how can Tenant assure that its leasehold position will also maintain its value? To do that, Tenant must know that it will never face the risk of paying too much rent.

1.1. *Typical Approach.* Landlords and Tenants typically resolve these concerns by agreeing that every two or three decades, they will reappraise the development site that Landlord originally delivered. In my experience, the annual ground rent will then adjust to equal 6% or 7%[2] of the then current fair market, i.e., whatever someone would pay to purchase the site

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1 Joshua Stein practices commercial real estate law at Joshua Stein PLLC in New York City. For information on the author, visit www.joshuastein.com. The author appreciates helpful comments from Stevens A. Carey of Pircher, Nichols & Meeks, LA; Carl Gaines, former editor of the Mortgage Observer, NY and now with Capital One Bank; Janet M. Johnson of Schiff Hardin LLP, Chicago; Alfredo R. Lagamon, Jr., of Ernst & Young LLP; Janice Mac Avoy of Fried, Frank, Harris, Shriver & Jacobson LLP; Donald H. Oppenheim of Berkeley, CA; Benjamin Polen of Polestar Realty LLC, NY; Elizabeth T. Power and later Karen Lively, the author's managing editors; Robert M. Safron of Patterson Belknap Webb & Tyler LLP, NY; Lawrence Uchill of Uchill Law, PLLC, Newton, MA; and Michael B. Vincenti of Wyatt, Tarrant & Combs, LLP, Louisville, KY. Alexa Klein, Deborah Goldman, James Patalano, and Lauren Silk, attorneys at Joshua Stein PLLC, also made substantial contributions, all very much appreciated. A prominent but anonymous New York City appraiser commented extensively on this article. Blame only the author for any errors. Earlier versions of this article appeared in the ACREL Newsletter; Mortgage Observer; New York State Bar Association Real Property Law Journal; Practical Real Estate Lawyer; ACREL Papers (March 2014 Kauai); and elsewhere. Readers are encouraged to comment on and respond to this article by sending email to joshua@joshuastein.com.

2 In the many Leases I see, old and new, I have been struck by how consistently the rent adjustment factor falls within that range, with only very few outlying cases. But my view

Footnote Continued on Next Page.

vacant. Until that happens, rent may go up a bit every year or few years[3]—or not, especially in older ground leases. Over time, ground rent often fails to keep up with inflation, at least until the next land value reset. In most cases, the rent never drops.

The reference to 6% or 7% in rent adjustment formulas has, again based solely on my own experience, mostly remained very stable for quite a while, even through the very low interest rates of the last few years. At the time of writing (early 2018), however, I have seen a few new transactions with a constant a bit below 6%. In one case, for example, Tenant proposed 4.5% and the parties settled on 5.25%. If interest rates rise significantly, 6% to 7% will probably again become standard.

Although Leases very often follow this approach, prospective Tenants sometimes worry about unpleasant surprises. Those surprises occur because, in a period of low interest rates, real estate investors are willing to accept lower rates of return. Hence capitalization rates in the overall real estate market eventually decline. This drives values, including land values, higher. If,

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of "market standard" reflects nothing more than the accumulated deals that happen to have crossed my desk—the piece of the elephant I happen to have touched. Others may have different experiences. For them, "market standard" may mean something else entirely. Ultimately, the "market" terms for any particular deal depend entirely on what those particular parties happen to negotiate taking into account the business context of their own transaction. In one transaction handled by the author involving a particularly unusual and desirable location, the parties negotiated a 10% constant. An older lease, predating the author's involvement, contemplated a 12% constant and threatened complete destruction of the leasehold.

3 These annual increases, typically small, add up significantly over time. They usually 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 of the Lease. Which party will benefit more from which type of cap will not always be obvious. The CPI adjustment will also often have a floor: either the rent can never go down or it will always go up by at least, e.g., 2%, even if CPI goes down. Over time, those annual floors can make the rent build up in a way that makes no sense—especially if the economy experiences deflation followed by inflation or the reverse—but caps and floors are definitely part of the territory in these annual adjustments. Even the routine calculation of those caps and floors can sometimes leave room for misunderstandings and misinterpretations. CPI adjustment formulas, especially if complicated, can sometimes produce surprises. Anyone writing such a formula should make it as simple as possible, but to paraphrase Einstein, no simpler. Someone else should test it. One must also consider exactly which inflation-based index to use—one version of the CPI or something else—and for what geographical area. The choice of index may matter. That issue lies beyond the scope of this article.

at the time of a rent adjustment, the capitalization value baked into land value[4] falls significantly below 6%, Tenant may find that the use of a 6% constant results in a completely uneconomic leasehold.

If Tenant's existing improvements cannot compete effectively against hypothetical new buildings, or if Tenant can only use the existing improvements for some use other than the "highest and best use" (if the land valuation reflects the "highest and best use" or something like it), this will compound Tenant's problems. It gets even worse for Tenant if Tenant's existing building has become landmarked, or if the existing use is no longer the "highest and best use" but it would be prohibitively expensive to alter the existing improvements.

These issues have worsened for Tenants in recent years in New York City, where former business/office districts, such as Park Avenue South and the Financial District, have seen a huge rise in residential development. Tenants may find themselves stuck with an office building whose highest and best use is residential condominiums, but Tenant has neither the ability (because condominiums may not be built on leased land) or the financial wherewithal to convert to residential. Yet the Lease reset formula may value the land based on the possibility of residential conversion.

1.2. *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. They never forget that the obligation to pay ground rent is almost always structurally senior to any leasehold lender's collateral.[5]

In response to these concerns, a lender or prospective Tenant will sometimes suggest a cap on ground rent adjustments. Typically, though, Landlord will regard any such proposal as a

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4 Assuming a reasonable volume of comparable land sales, the appraisers will typically prefer to rely on comparable sales rather than capitalization of projected income at current capitalization rates. But those land sales also reflect a capitalization of projected income, as estimated by buyers/developers, using current capitalization rates, so ultimately the analysis gets to the same place.

5 This assumes, of course, that Landlord will not 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. This article accepts it as part of the territory. In the rare case where Landlord joins in Tenant's leasehold mortgage, Landlord should reasonably demand some extra compensation for the extra risk assumed. Occasionally, a Lease will "subordinate" part of the ground rent to payment of debt service. If the lender ever foreclosed, then the "subordinated" component of the ground rent would go away. This is quite uncommon, though.

non-starter, because it necessarily undercuts the inflation protection that Landlord sought through the future ground rent adjustments.

Applying a fixed percentage (e.g., 6%) to future land values will create problems for both Tenant and its lender—and wonderful results for Landlord—if, at the moment of the rent reset, valuations in the larger real estate market use capitalization rates significantly below the fixed percentage specified in the Lease. At any such time, real estate values will reflect a capitalization of future income at, say, 4%, but the Lease will require payment of ground rent at, say, 6% of that capitalized amount, which may put Tenant in an untenable position and undercut or destroy the value of the leasehold lender's collateral.

Any Landlord will point out that any concern about Tenant's position should be tempered by thinking about Landlord's position under many ground leases. These leases often start out with a free rent period, followed by at least a few decades governed by a fixed rent schedule that, in many cases, does not rise as fast as real estate values. So naturally when the rent adjusts to market, Tenant's "good deal" will end and this will cause shock. But the shock is simply a correction for a rent schedule that protected Tenant from the market, often for an extended time.

1.3. *Linkage To Interest Rates?* Some Leases try to mitigate the risk of shocking rent increases 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 a spread.

Although some commentators may have seen a trend toward this type of formula, I have not. Like many of the comments in this article about "typical" practice, though, my failure to note the trend might only reflect the particular universe of Lease transactions that I have been involved with or seen recently. Or it could reflect a market perception that in the long run—i.e., multiple business cycles—6% or 7% has worked reasonably well, and there's no reason to think it will stop working reasonably well any time 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, Tenant may get lucky.

1.4. *Fair Market Rental Value?* Very occasionally, the revaluation might direct an appraiser to determine the new rent based generally on market conditions for newly negotiated 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, with no formula to derive the rent adjustment from land value or anything else. The Lease drafters must still define with absolute clarity how fair market rental value is to be determined. They also must define any assumptions the appraiser should consider in that process. Does the appraiser consider vacant land? The existing improvements? If improvements are taken into account, any such adjustment creates a substantial risk that, after adjustment, the leasehold will have no value to Tenant.

Assuming the "fair market rental value" determination refers to land value only, it probably would require the appraiser to reverse-engineer a typical land value rent reset. First, they would consider current Lease negotiations, identifying the land value constant percentage that market participants typically agree on, at the time in question, in those negotiations.[6] As of mid 2018, that constant would probably be 6% or perhaps slightly below that. Second, the appraiser would turn to determination of land value in the usual fashion. So a reference to "fair market rental value" would require the appraiser to make two market-based determinations rather than one. That creates more work and more risk of mistakes, but might protect Tenants from the risk of, e.g., a 6% land value constant at a time of very low capitalization rates in commercial real estate. While in theory this approach may seem fair, lenders will hate it because of its uncertainty. Hence it may be unfinanceable.

1.5. *Valuation On A Range Of Dates.* 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. If that period ends on the intended rent reset date, then the valuation process will automatically undercompensate Landlord a bit if real estate values are rising over that period, which they usually (but not always) do over any extended period. The midpoint of the valuation period could instead be the intended rent reset date, with suitable adjustments once the final average value has been determined.

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, Landlord would probably feel victimized by a very low valuation.[7] Going forward, that particular Landlord might favor using an average of the values on multiple dates over multiple years.

If the parties agreed to a valuation on a range of dates, would that mean, for example, they would need to order five complete appraisals? As a general proposition, appraisers like to do a complete job as of a particular date. They say an appraisal speaks only as of that date, taking into account all relevant circumstances as of that date. Unless the parties varied from that

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6 Two possible land value constants might apply. First, the appraisers might look at newly signed Leases and examine the ratio, expressed as a percentage, between the initial rent, with suitable adjustment for any rent abatement, and the value of the land at that time. Second, the appraisers might look at how those newly signed Leases set up future land value rent resets—what percentage constants do they use? Those two possible land value constants will not always match up perfectly, even though one might think they logically should. If the Lease doesn't contain clear instructions, the appraisers will need to make a judgment call, thus introducing further uncertainty and room for dispute. Whichever party dislikes the outcome will claim the appraisers got it wrong.

7 In all likelihood, however, this Landlord's victimization was mitigated by the fact that the Lease probably said ground rent could never go down, even if land values dropped. So it could have been worse for Landlord. And Tenant may have felt victimized by having to pay ground rent higher than what it should have been based on pure land value at the time of the reset.

principle by contract, they would in fact probably need to obtain five appraisals, significantly driving up the cost, time, and potential for disputes.

With suitable advice from an appraiser, though, they might be able to negotiate a specific "primary" appraisal date, with only certain adjustments to be made based on specified market conditions (e.g., capitalization rates, vacancy rates, and general inflation) on other dates before and after that primary appraisal date. Any such appraisal structure would break new ground, as well as new ground for disputes. It could also create problems for appraisers, who always want to value land as of a specified date.

Landlords and Tenants generally prefer, however, to avoid the time, expense, drama, 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 historically both parties have seemed generally willing to take their chances. And Landlord derives some comfort from the fact that any Lease usually says rent can never go down.

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

For instance: should the appraiser appraise raw land, or should the appraisal include improvements? Should the appraisal 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 that disagreement, by telling the appraiser whether or not (and how) to consider the improvements on the site. In general, the appraiser should try to replicate whatever existed when the parties signed the Lease, usually vacant land.[8] To avoid confusion, the Lease should say that as clearly as possible. And Tenant should remember that if Tenant plans to build improvements, any land value calculation should typically disregard those improvements.[9]

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8 What if that vacant land had serious environmental contamination at inception of the Lease? Should those circumstances count as deductions when valuing the land at some later date for a ground rent reset? After all, Tenant will spend money to clean up the mess, so why should future land valuations give Landlord the benefit of that cleanup, any more than Landlord should get the benefit, for valuation purposes, of Tenant's beautiful new office tower?

9 Although this statement is usually true, the author has seen ground rent reset disputes where Tenant can reasonably argue that land and building, together, are worth less than vacant land. This can occur, for example, if the building is obsolete and far below current

Footnote Continued on Next Page.

Perhaps the appraiser should consider the leased land in the context of surrounding land. For example, suppose the leased land consists of a small midblock site that a future developer might conceivably at some point redevelop as part of a larger assemblage. Does the potential of such an assemblage justify a higher appraisal? What if, at the date of determination, such an assemblage and redevelopment has actually occurred? These are great questions but might best be left to the appraiser. On the other hand, Landlord or Tenant may feel more comfortable if the Lease handles them expressly. Silence leaves the possibility of a fight.

1.6. *Ground Leases Of More Than Just Ground.* If improvements existed at Lease inception, and Landlord initially demised those improvements to Tenant along with the underlying "ground," the market will often still call the transaction a "ground lease," even though it covers existing improvements and not just ground. The characterization as a "ground lease" would depend largely on whether Tenant's rights and obligations looked more like ownership (an investment transaction, with value in the marketplace, and typically regarded as a "ground lease") or more like mere rights of occupancy not readily salable or financeable in the market (a "space lease").[10]

If a Lease demises improvements that exist at the time of lease inception, the rent reset should usually consider only the improvements as they existed at that time. If, for example, Landlord delivered an old warehouse with "solid bones" ready for redevelopment, then the rent reset clause should require the appraiser to figure out what that particular building would be worth at the time of the rent reset, if it were still in the same condition as when Landlord delivered it. This requires the parties to somehow take a snapshot of the existing building at Lease inception. This can entail a literal snapshot—a collection of photographs—as well as a conceptual description, written with a relatively broad brush. Later, the appraiser needs to

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market standards, requires tremendous capital expenditures, or is stuck with an outdated use not readily changed.

10 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 Lease—not placing great weight on whether the Lease demises any ground, raw land, or a building. Others, including Black's Law Dictionary and some prominent New York City commercial real estate lawyers, disagree, arguing that a "ground lease" needs to demise some ground, or it isn't a "ground lease." In the author's mind, if it is an investment/development transaction and Tenant has substantial control and flexibility, then it's a ground lease. If it is an occupancy transaction or Tenant's hands are tied regarding the space, then it is a space lease. If it starts out demising ground, it will soon enough cover a building as well, and it's still a ground lease. For more on the distinction between a "ground lease" and some other form of lease, please see GROUND LEASE VS. BUILDING LEASE (WHAT'S A GROUND LEASE ANYWAY?), in the Encyclopedia of Ground Lease chapter in Joshua Stein's upcoming book on ground leases.

understand what hypothetical physical condition of the building is supposed to be appraised, so the parties need to document it in some reasonable way.[11]

Of course, if the existing improvements at Lease inception have no value and Tenant will need to demolish them. Tenant might go a step further, arguing that any future valuation of "raw land" overstates the value of what Landlord delivered, because Landlord delivered land with improvements that required demolition. So, at the time of the reset, Tenant would argue the appraisers should try to value raw land (as if vacant) and then subtract the cost of demolishing the obsolete improvements from that value. If Landlord has any negotiating leverage at all, Landlord will typically be able to reject that concept.

A sloppy rent reset clause might, however, unintentionally require the appraiser to take into account any development, upgrading, or expansion that Tenant accomplished. This reasonable-sounding minor detail would effectively force Tenant to pay rent in exchange for value that Tenant rather than Landlord created or provided. Forcing Tenant to pay twice for whatever (re)development Tenant accomplished—once when doing the work, a second time by paying adjusted rent based on the completed work—hardly seems "fair." Fair or not, Lease language should resolve that question and not leave it to courts, appraisers, or arbitrators.

Occasionally, though, at the time of any rent reset the improvements are obsolete and a net minus to value. In those cases, Tenant will argue that the appraisal should consider the improvements as part of the value of the site, because land and bad improvements together are worth less than just raw land. As a variation, Tenant may try to argue that the land should be valued to take into account only the potential to build whatever improvements actually exist. None of these arguments should ever actually need to occur, though, because the lease should prevent them.

1.7. *Future Changes In The Site.* Any Lease negotiator also should consider possible future disconnects between the development potential of raw land (assumed to be unimproved, and available for development to its highest and best use consistent with then-current law) 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. If at some future date the municipality decides to double the permitted bulk on the same land, then the same land could in the most extreme case double in value overnight, assuming the site can feasibly exploit all the new bulk.[12]

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11 As a simpler alternative, perhaps future appraisals could consider hypothetical vacant land, and then add some agreed percentage to reflect the value of the improvements that existed at Lease inception.

12 In New York City, the right word for "bulk" is "floor area," as defined in the Zoning Resolution. By referring to floor area, one avoids potential disputes over the meaning of developable space in a building. In contrast, "gross building area" is something else, potentially larger, and "rentable area" is a highly elastic and potentially fictional concept.

Footnote Continued on Next Page.

Similarly, suppose zoning allows only construction of, say, a hotel at Lease inception, and so Tenant proceeds to build a hotel. Then suppose the municipality in its wisdom later decides to allow a wide range of additional uses, one of which is more valuable (at the time of rent reset) than construction of a hotel.

For the rent reset, though, the parties need to consider one not-so-minor detail: if the transaction played out as the parties originally anticipated, then by the time of the rent reset Tenant 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 (or different and more valuable) development than the building already in place at that time, then that upzoning does not help Tenant much. If Tenant must pay rent for newly created development potential (or the ability to change to a more valuable use) that Tenant cannot really exploit, or if Tenant's existing structure can't generate net operating income equivalent to the hypothetical new construction that the improved zoning would allow, then Tenant's leasehold may no longer make economic sense. The parties can address this issue in a few ways.

- *Actual Exploitation at Time of Reset.* If at the time of the rent reset, Tenant has actually exploited the site's increased development potential, then it's reasonable to take that greater development potential into account for the land valuation.

- *Additional Reset Date*. If at any date in between land value rent resets, Tenant actually does exploit the increased development potential, then Landlord can require an additional land value rent reset, perhaps after some reasonable waiting period.

- *Long Waiting Period*. Even if Tenant has not yet exploited the increased development potential but a certain period has passed since the change in zoning (e.g., 25 years), then Landlord can require any later appraisal to consider the improved zoning, whether or not Tenant has figured out a way to exploit it. In effect, the Lease would force Tenant, over time, to exploit any enhanced development potential. It is a first or second cousin to the classic "single-tax" plan advocated by Henry George, John Locke, and Baruch Spinoza, by which the government would tax vacant land based on its highest and best use to encourage the landowner to develop that use for the benefit of society (or, in this case, to encourage Tenant to develop the land for Landlord's benefit).

Just because the Zoning Resolution allows a certain amount of bulk on a site, that doesn't mean a developer could actually build a structure using all that bulk. Height limits, sky exposure planes, setbacks, and other constraints might limit the use of bulk otherwise available. Wherever the text refers to Tenant's exploitation of available bulk, that refers to bulk that Tenant could in fact use given all constraints that apply to the site.

Any of these possibilities must recognize that a complete redevelopment of a structure is not the real estate equivalent of changing clothes. It is probably unfair to expect Tenant to squeeze every dime out of a property for the passive Landlord who bears far less risk in redevelopment—except Tenant bankruptcy—than Tenant faces, and who, after all, has not sold its property and will receive the land back at the end of the Lease term. The time, risk, cost, and ingenuity entailed in redevelopment should perhaps be valued and deducted from any of the above reset formulas.

Conversely, if zoning changes have reduced the permitted development on the site, but Tenant's improvements are now overbuilt and can remain as a legal nonconforming use, then Landlord would argue that the revaluation process should ignore the downzoning. On the other hand, if the overbuilt improvements had burnt down and could not be restored, Tenant would argue for rent relief. Landlord's response would depend in part on whether, after the fire, Landlord received enough insurance proceeds to justify a rent reduction.[13]

Another question along those same lines: should newly discovered environmental issues affect 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 Lease. And what if some government decides to issue a landmark designation for the existing improvements?

1.8. *Appraisal Subject to Terms of Lease.* Landlord and Tenant might also find themselves fighting over whether any appraisal of the land should "consider the terms of the Lease," a concept that appears in many older ground rent adjustment clauses and a few newer ones. In New York, if the Lease is silent, the fair market value will be deemed to be subject to the existence and terms of the Lease.[14]

The whole concept seems circular. That's because the value of Landlord's land, if considered subject to the terms of the Lease, will depend largely on the amount of the ground rent, assuming Tenant is reasonably likely to actually pay that ground rent. Thus, it may not make sense to consider the ground rent in measuring the value of the land for purposes of determining the ground rent.

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[13] In any discussion of Leases, many roads lead to issues of condemnation and casualty. The problem of an "overbuilt" building arises regularly. Any building could, at some future point, become "overbuilt" if the site is later downzoned. So the issue can arise anywhere, any time, in any Lease, not just for Leases that demise buildings that one already knows are "overbuilt." Many Leases don't adequately address that possibility.

[14] 936 Second Avenue L.P. v. Second Corporate Development Co., Inc., 10 N.Y.3d 628; 629-30 (2008) ("[T]he issue is whether the net lease itself must be considered by appraisers in valuing the demised premises for purposes of establishing the net rent for a renewal term of the lease. Because the net lease does not exclude its consideration, we conclude that it must be taken into account in valuing the property.")

One can eliminate any possible circularity by deciding that the parties probably did not intend to create an indeterminable formula. Instead, the parties must have meant that any valuation of the land should take into account any Lease terms that limit permitted uses or other rights of Tenant. That is probably the best way to interpret any reference to appraising the land, considered subject to the terms of the Lease.

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 Tenant 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, if treated as binding restrictions on use of the land. It makes sense: if the Lease allows Tenant to construct only a car wash with an ancillary coffee shop, then Tenant 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 appraiser should consider anything else in the Lease, except ground rent, that—if hypothetically treated as a burden on Landlord—increases or decreases the value of Landlord’s position. For example, if the Lease gives Tenant a below-market purchase option, this will lower the value of Landlord’s position. And what if the Lease requires Landlord to deliver to Tenant 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”? What if the Lease limits Tenant’s financing to 50% of the cost of Tenant’s construction?

If the Lease has only a decade or two left in its term, then perhaps an appraisal “considering the terms of the Lease” should consider the fact that, as an economic matter, Tenant doesn’t have enough “useful life” left to justify a major construction or redevelopment project. Should the appraiser consider that as a negative in measuring the value of the land “subject to the terms of the Lease”? Isn’t the short remaining life of the Lease a term that ought to be considered? But does it really affect the value of the land in any way?

These are all fascinating questions. Tenant could raise any of them as an argument to lower the value of the land for the rent reset. Litigators and courts and expert witnesses could have a lot of fun and deep thought resolving all these issues. Lease writers should deny them that pleasure. Again, the words of the Lease rent revaluation formula should leave no uncertainty. Of course one still needs to count on the appraisers to read those words and interpret them correctly.

As another variation on this theme, in New York, a developer generally cannot construct for-sale condominium apartments on a Lease. It’s just prohibited, except in a few favored locations. So if the appraisers must appraise the land “considered subject to the terms of the

Lease," does this mean they should disregard any incremental value that might result from the potential ability to develop condominium apartments on the site?[15]

Over an extended time, differences of opinion on these and similar issues translate directly to dollars—lots of them. Any careful Lease writer 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 the appraiser should consider, and what assumptions the appraiser should make. If the appraiser should assume Tenant can operate only the narrow scope of uses the Lease allows, that's what the appraisal clause should say. If other particular provisions of the Lease should increase or decrease value, identify them. 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, everyone hopes (one hopes) 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—6% or 7% 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 Landlords and Tenants 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 or have historically done it), and that lenders have underwritten and financed similar leaseholds for decades.

1.9. *Is There A Better Way?* Landlords and Tenants 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 Tenant's revenues, at least in part. Landlord could receive some percentage of "gross revenues," perhaps after modest deductions, and perhaps with a floor.[16] That percentage might reflect the expected ratio between the value of the land and the value of Tenant's completed development project.

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15 Conversely, if the Lease says nothing about any of this, should the appraiser value the hypothetical vacant land as if it could be developed for condominiums, even though the developer (Tenant) can't legally undertake that sort of development? In New York at least, the *936 Second Avenue* case cited above probably means: (a) the appraiser must consider the existence of the Lease; (b) the existence of a Lease precludes condominium development under New York law; and therefore (c) the appraiser should not consider the possibility of condominium development.

16 In a hotel or other asset with multiple revenue streams, different percentages might apply to different revenue streams, perhaps changing with market conditions. Although that sounds brilliant—and a good way to protect Tenant from uneconomic ground rent

Footnote Continued on Next Page.

It sounds reasonable. But what if Tenant 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 Tenant does a lousy job with subleasing, or fails to invest the capital necessary to achieve the highest rents? And what should the Lease allow Tenant to deduct? Leasing costs? Capital expenditures necessary to attract space tenants? Unexpected energy costs or uninsured casualty repairs? If Tenant borrowed money to improve the property, should Tenant have the right to deduct debt service? Interest? At what rate? How does Landlord know Tenant is not lying or artificially reducing its revenues? Before long, the exercise reinvents the Internal Revenue Code.

If Landlord and Tenant do decide to go down that road, then they (particularly Landlord) 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 Landlord a low percentage of a broadly defined variable without many deductions. Gross revenue with no deductions at all 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. Consider the issues that have arisen with shared appreciation or cash flow mortgages. 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 rent formula that awards Landlord a share of Tenant's financial results will work best (if it works at all) as a continuing participation with annual calculations and payments. Otherwise, it gives Tenant an opportunity to game the system at the time of the rent reset. Tenant could, at that time, claim poverty. Or, in the years just before the reset, Tenant might undermanage the building, e.g., by deferring any necessary upgrades until just after the rent reset.

Any participation rent formula in a Lease might also award Landlord "transaction payments," i.e., a small percentage of capital transactions such as lease assignments, refinancings, or other transactions tantamount to either. Transaction payments seem particularly common in leases from governmental entities, where politicians worry about bad publicity if a developer realizes a "windfall" but the governmental entity receives nothing. In the author's experience, the legal fees that go into negotiating transaction payments typically exceed any payments to the governmental entity by the time the developer finishes claiming deductions.[17]

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obligations—it also sounds like a wonderful source of future business for litigators, consultants, expert witnesses, and appraisers. But maybe that's always true for any form of contingent rent adjustment.

[17] For a similar dynamic, see the entry on "Hollywood accounting" at www.wikipedia.org.

If Tenant agrees to pay Landlord transaction payments, then 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 produce disputes down the line.

For example, does a "refinancing" include the case where 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? 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 mortgage, probably larger? Should Tenant's first construction loan be exempt from any payment to Landlord? First permanent loan? If multiple sales of the leasehold occur, should Landlord participate only in the "profit" since the last sale? What about multiple refinancings over time? If Landlord 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? What if Tenant uses the proceeds to repay additional equity investment the project needed?

These questions only scratch the surface of the issues that can arise once Landlord and Tenant start down the percentage or participation rent road.

1.10. *Small Percentages—Not So Small.* Setting aside the many opportunities for dispute that arise in measuring any participation rent, even a very low percentage of Tenant's gross revenues can place a very significant burden on Tenant, giving Landlord a correspondingly significant stream of participation rent. Suppose, for example, that Tenant agrees to pay Landlord 3% of a truly gross measure of revenue, with no meaningful deductions at all. A payment of just 3% of gross sounds like a really small percentage.

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

After those deductions, Tenant really gets to keep only 20% of its gross revenue. So Landlord's 3% share of that gross revenue represents almost one-sixth of Tenant's bottom line. Moreover, Tenant might operate at a loss even though gross revenue seems substantial. In other words, instead of adding up to 80% of gross revenue Tenant's expenses could add up to 105%.

In all these cases, paying even a very small percentage of gross revenue to Landlord can put quite a dent in Tenant's ultimate bottom line. Assuming Tenant will consider the concept at all, Tenant 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 tenant to offset real estate tax escalations against percentage rent. Similar considerations arise if Landlord will receive a percentage of refinancings, lease assignment proceeds, or other capital transactions.

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

If the project consists of an up-to-date office building, for example, the participation rent determination could assume Tenant 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 Tenant's actual financial performance. Tenant would then pay participation 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 Tenant will worry that circumstances or issues peculiar to this property will prevent Tenant from achieving strong enough actual results to match the benchmark-based participation rent the Lease requires Tenant to pay. If the parties keep Landlord's participation low, dumb, and simple, then Tenant may be willing to live with that risk and the corresponding benefit Tenant will realize if Tenant produces results higher than the benchmark might suggest.

Yet another possibility: the developer might agree to give Landlord a small "carried interest" in the Tenant entity. Any carried interest will, however, raise another host of issues, some but not all of them variations on the problems discussed earlier. Many of the carried interest issues will arise because 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 Landlord'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.[18]

Ground leases do occasionally provide for percentage or participating rent along at least some of the lines suggested above. Such provisions are, however, not common. They also create ample opportunity for new disputes.[19]

As yet another variation on the percentage rent arrangements suggested above, sometimes a Lease will periodically reset base rent taking into account Tenant's net operating income over some test period, e.g., Tenant's average net income during the three years before the reset. The base rent then increases to equal some percentage of net income, though the base rent can never go down. Although this makes sense and protects Tenant from unpleasantness, it also raises most

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18 Many of these issues also arise in negotiating a joint venture. See Joshua Stein, Agenda for a Joint Venture Agreement, 56 The Practical Lawyer 36 (April 2010) (www.pdf2go.org/165.html).

19 As one example, the author served as an expert witness in a dispute that arose over a similar participation arrangement, not involving payment of ground rent, where the payor wanted to set up huge reserves and subtract them before calculating participation payments. See *Building Service Local 32B-J Pension Fund vs 101 Limited Partnership,* N.Y. State Sup. Ct., Decision After Nonjury Trial, March 7, 2016 (Index No. 652266/2010).

of the same issues (discussed above) as any other method of rent adjustment that looks at Tenant's financial results.

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

1.11. *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, have historically believed the CPI rises faster than real estate values and rents; hence, they may propose a cap on the adjustments.[20] But if the parties cap any periodic rent adjustment, then Landlord will not achieve its goal of protecting itself from inflation. Without a cap, though, Tenant may have trouble obtaining financing.

In the author's experience, Landlords and Tenants have recently been willing to live with uncapped CPI adjustments in place of land value resets.

Perhaps the parties can find an index better than CPI, published and reliably updated over time by some authoritative third party. Possibilities might include such measures as Class A office rents, average daily rate for hotel rooms in a certain market stratum, real estate tax assessments, or retail rents, in each case for some defined local geographical area and taking into account intended use (and any future flexibility in use) of the improvements. Real estate professionals may have varying degrees of confidence in any possible index. They would need to choose accordingly.

Based on this approach, future changes in the chosen index would drive changes in the ground rent, regardless of what a particular Tenant does or earns in the demised premises. Such an index could make sense, assuming it matches likely uses of the site. A combination of multiple indexes might also work, though it might not ultimately differ significantly from

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[20] Historically, over any extended period 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, and those made some old ground rents look silly. Looking back over the long term, though, CPI has not grown all that dramatically. It has certainly not been "out of control" over the long term or even the last 30 years. 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 over any extended period, and Washington, DC, where growth of the federal government may have led to land appreciation far beyond CPI growth. 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 nonauthoritative but also nontrivial research in the area. Further insights on these crucial issues will be welcomed.

measuring participation rent based on a marketplace benchmark of what Tenant "should have earned," as suggested above.

As yet another alternative, a 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. Any such index would need to reflect local market conditions; have a reasonable history; and have a high likelihood of surviving for multiple decades. Today such an index does not seem to exist.

Ground leases once required tenants 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."[21] A federal court validated such a clause as recently as 2008.[22] Gold clauses certainly would have protected landlords from inflation in the recent past, at least until the price of gold dropped in the particularly recent past. Until that recent adjustment, in most of 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.

Tenants, 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, Landlord may worry that gold has run its course, or that during the Lease term gold might no longer function as a reliable repository of value. Landlord may also note that a gold clause has no particular correction with the future value of this particular site. Landlord might care more about that value than about the general value of the dollar.

To the extent that the parties agree on any index or other form of reference point, they have to worry about what might happen to it in the long lifespan of their Lease. If the index or reference point goes away, then Landlord will want the right to propose some reasonable substitute, but Tenant won't tolerate that level of Landlord control. Hence another dispute and another arbitration.

1.12. *Recalibration Of Relative Values.* The parties could also try to devise a rent adjustment structure in which, 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 Lease used, it would contemplate a valuation of both Landlord's and Tenant's position, after taking into account the contemplated adjustment. Then the Lease would also add a requirement—and, to assure it, another step in the 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.

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[21] 31 U.S.C. § 5118(d)(2).

[22] 216 Jamaica Ave., LLC v. S & R Playhouse Realty Co., 540 F.3d 433, 441 (6th Cir. 2008).

For example, if the initial ground rent were calibrated to give Landlord a position worth 34% 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 a disproportionate amount of 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 Tenant would point out that any such mechanism must also consider the additional capital investment Tenant 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 Tenant's investment and brilliant development, leasing, and management strategies, how does one slice up the resulting increase in value?

Landlord would respond by saying any such capital investment is part of what Tenant undertakes when signing a Lease. Tenant avoids the need to finance the cost of land acquisition, but in exchange bears the burden of paying ground rent and figuring out, over time, how best to exploit the real estate. That burden includes the obligation to make capital expenditures to keep the building up to current standards.

These issues become 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 arising whenever a 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, Tenant'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. Aspirin may help.

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 Landlord's share of overall gross revenue (or, less desirably, net operating income before ground rent) ever drops below a certain percentage, then Landlord 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 Landlord's share ever rose beyond a certain percentage of gross revenue, then ground rent would drop, but never below the fixed rent schedule. Arrangements like these can give Landlord 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, both (a) the need for omniscience in considering all possibilities;

and (b) the risk of disputes. They tempt Tenant to game the system in any number of ways, while exposing Landlord to the risks of Tenant's bad business judgment. For example, Tenant might underinvest in the improvements, not keep up with their "highest and best use" or even just current industry standards over time, or allow them to become obsolete. Landlord typically wants none of that when signing a Lease.

As a more practical variation on this theme, the parties could agree that, after each rent reset, the value of Landlord's position must never exceed a certain percentage of the value of the whole asset (land and building, appraised as if the Lease did not exist), and also can never fall below some other percentage of that value. To adjust for the possibility of Tenant incompetence or dereliction, the value of the whole asset would need to disregard any loss of value resulting from Tenant's failure to comply with the Lease. This raises once again the issues of capital expenditures and mismanagement discussed above.

1.13. *Rent Adjustment Timing.* Anyone who negotiates future rent adjustments in a Lease should also consider how the timing of those rent adjustments interacts with the timing of Tenant's renewal options. In Tenant's perfect world, each rent adjustment period would correspond to an option term. Tenant would know the adjusted rent before needing to exercise a renewal option. As an equivalent alternative, Tenant could have the right to withdraw the exercise of an option if Tenant 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 Tenant is roughly equivalent to Tenant's right to walk from the Lease at any time. That walk-away right always gives any Tenant the ability to try to negotiate the rent downwards at any time. The ability to not exercise—or withdraw the exercise of—a renewal option would create much the same leverage.

The dynamic changes, of course, if Tenant has significant credit or a creditworthy guarantor, or if credit enhancement measures, such as a security deposit or a letter of credit, back Tenant's obligations. In those cases, Tenant can't so easily threaten to walk away from the Lease, so Tenant truly realizes a benefit by knowing the adjusted rent before the deadline to exercise the renewal option.[23]

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[23] In a typical Lease, even a creditworthy tenant may not have much "walk-away exposure." Most leases, including ground leases, allow Landlord to sue a defaulting tenant for the excess, if any, of the reserved rental over fair market rental value for the remaining term, discounted to present value. Usually no such excess exists. The Lease has value to Tenant precisely because the ground rent is below fair market value. Thus Landlord cannot sue for a huge lump sum if a creditworthy tenant decides to walk. Landlord might mitigate that problem by making it clear that "fair market rental value" refers to just the land, not the entire "premises," but even then the land rent will often not exceed market rental value. In that case, to recover, Landlord may need to leave the Lease in place and sue monthly for unpaid rent—not too appealing. Perhaps Landlords should think more about

Footnote Continued on Next Page.

A more balanced approach might require Tenant 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—a right that Tenant typically has at all times after completion of construction. 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.

1.14. *Valuation Date vs. Rent Reset Date.* As another timing issue, much less fundamental, any land value rent reset must define the effective date as of which any new land value will be determined. Will the appraisers use as a valuation date the same day the rent reset will become effective? In that case, the parties will very likely not know the new rent number as of the date the new rent becomes effective. That uncertainty creates a housekeeping issue, because the parties will need to determine how much interim rent Tenant must pay during the appraisal process and resolution of any possible dispute.

If the parties are far apart in any such dispute, the determination of interim rent could have significant practical economic consequences for the parties. It seems reasonable and "fair" to set interim rent as the average of the last proposals made by each party before the effective date of the rent reset. There are, of course, other ways to handle that issue, but it's something the parties should not overlook. This issue does not just represent a hypothetical eventuality. To the contrary, it's highly likely to arise, especially if the valuation date matches the first day of the rent reset.

To try to avoid that drama, the parties might agree upon a valuation date that is six months or longer before the effective date of the rent reset itself. That timing gives the parties a window in which to resolve their dispute—whether through negotiations or a complete appraisal or arbitration process—before the rent actually adjusts. If, however, one assumes that in the long run real estate values always rise -- typically 3% a year in the long run—an accelerated valuation date may deprive Landlord of the benefit of some real estate appreciation, though it also protects Landlord from a short-term decline in the market, if that occurs.

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the measure of damages for a Lease default. Of course, any Landlord might happily recover possession of a completed building (and sometimes a security deposit) and call it a day. That right gives a typical Landlord its best security for payment of ground rent, plus a graceful way to recover if Tenant decides to default. That statement applies, of course, only if the ground rent is significantly below market rental value for the land and improvements, and the improvements are in reasonable condition. If the "ground lease" originally demised both land and building, then Tenant might have no equity at all in the leasehold during a depressed real estate market.

The parties might, and usually do, ignore that issue, treating it as one of the consequences of having an agreed valuation date, an element of their business deal. Or they might agree that once the appraisers determine the land value as of the valuation date, landlord can require a slight adjustment (a percentage or two or something based on CPI) to account for appreciation that would have occurred from the land valuation date until the rent reset date. Most Leases contain no such adjustment. But any Lease should define the valuation date with absolute clarity and handle the likely circumstance where the rent is supposed to adjust before the new rent is actually determined.

1.15. *Real Estate Derivatives?* Landlords and Tenants 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 real estate 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 its transaction costs are likely to be high until a broad market emerges.

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, and brilliant legal minds, 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 overestimate categorically their own intelligence and ability to "get everything right" in the context of ever-more-complex deal structures and terms.[24] The more complex and creative the various gradations and nuances become, the more likely the parties will get them wrong or miss something that turns out to be crucially important. Problems seem particularly likely to arise if, for some reason that seems good at the time, the parties agree that the rent reset formula will change at some point in the distant future. The parties may forget about the change, or it may be negotiated and written at the last minute in a sloppy way. It also invites dislocation and disputes.

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24 For more on this topic, see Joshua Stein, It's Complicated, But Is It Right?, The Mortgage Observer (monthly supplement to The New York Commercial Observer), February 2013, at 12 (www.pdf2go.org/100006.html). The author's expert witness assignments mostly involve complex and nuanced documents for large transactions. Aside from Leases, the line-up can include joint venture agreements; development agreements; intercreditor agreements; and loan documents, particularly nonrecourse clauses and carveouts. With the help of teams of great minds, these documents cover every possible eventuality perfectly—often in great detail and at great length—except, it seems, the one eventuality that actually occurs. Hence the litigation.

Complexity and sophistication of this type will leave land mines in a Lease, just waiting to produce unpleasant surprises when inspected under a high-powered microscope in a real world full of entropy and unanticipated possibilities. The incredibly complex language and multi-page sentences that are so common in today's real estate documents often manage to include some imperfection. All it takes is one imperfection to fuel years of litigation. 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 any land valuation rent reset—the fallibility of lawyers often becomes particularly apparent. They try to think of everything but don't always succeed.

Legitimate fear of complexity, legitimate fear of change, and the constant need to satisfy future lenders will often drive Lease negotiators back to the traditional rent adjustment formula described at the beginning of this article, assuming Tenant and Leasehold Mortgagee are willing to accept any uncertainty at all.

They may prefer instead a much more dumb and simple approach: a fixed and defined stream of rent, so that an exhibit to the Lease lists each calendar year during the Lease term and then says how much rent Tenant must pay in that year. For example, in the year 2043, the rent will be $973,252. The rent can certainly rise over time, but each increase is scheduled and defined in advance. In the current market as of 2018, one would expect those fixed increases to equal 2% to 2.5% of the previous year's rent. That percentage is fairly consistent with long-term real estate appreciation, even in New York City. The result: a fixed and defined stream of payments, the equivalent of a long-term bond, with Landlord receiving back a building (for whatever that might be worth in its then-current condition) at the end of the Lease term.

Investors figure out how to value such bonds all the time, using whatever discount rate they think makes sense. Landlord might be willing to perform the same analysis, in effect trading its real property for a stream of bond payments. In a Tenant-friendly market, Landlord may have no choice if Landlord wants to make a deal. If the payments start out at an appropriate level and contemplate attractive periodic increases, the transaction just might make sense for Landlord. And it should produce ecstasy for Tenants and Leasehold Mortgagees, who can figure out exactly what they are getting into without the risk of surprises in future years. If, however, Landlord wants to "stay in the real estate business," a fixed rent schedule won't have much appeal.

1.16. *Lessons Learned.* Anyone negotiating a Lease may want to keep in mind these lessons distilled from the preceding article:

- *Industry Standard*. The industry standard, at least in New York City, remains: (a) small bumps every year or few years; and (b) a reset to 6% or 7% of land value (or perhaps a slightly lower percentage) every two or three decades.

- *Not "Subject to Terms of Lease."* Don't try to value the land "subject to the terms of the Lease." Instead, define what assumptions you want the appraisers to use. Which restrictions in the Lease should the appraisers consider?

- *Simple*. Whatever you do, try to keep it simple. Test it. If your language contemplates an appraisal, ask an appraiser to look at it. Make sure your language will allow the appraisers to do their job without getting confused.

- *Overthinking, Future Changes.* Resist the urge to overthink and make your rent reset formula overly nuanced. It often won't play well two or three decades from now. That's especially true if you agree that the formula will change in some way in the distant years.

- *Percentage Rent.* Percentage or participation rent can sometimes work but, again, try to keep it simple with as few deductions and variables as possible. Take a small percentage of a big number. Test your formula carefully.

- *Fixed Rent.* Don't rule out the possibility of a fixed rent schedule, with fixed bumps. Lenders love it. With the right numbers and the right discount rate, it may work for Landlord too.

4841-8192-8209, v. 45

SAMPLE ARBITRATION LANGUAGE[1]

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For reference and possible use in transactions, we offer four samples of possible arbitration language. The first two samples are primarily intended for ground leases with possible rent resets based on Land Value. The third sample sets out a simpler process for other disputes, typically of lesser magnitude, e.g., reasonableness of withholding consent. The fourth sample is specific to arbitration where the parties cannot agree on the final form of documents for a transaction. We encourage anyone using this language to: (a) review all four options and use whatever provisions they think will work best for their particular situation; and (b) make sure all capitalized terms have been appropriately defined taking into account the overall document.

1. LAND VALUE ARBITRATION (OPTION 1)

1.1. *Definition.* "Land Value" means, on each Land Value Reset Date, the fair market value[2] of the Land at that Land Value Reset Date, determined under this Article.

1.2. *Agreement and Arbitration.*[3] The parties shall try to agree on Land Value at least **__** months before each Land Value Reset Date. If they do not agree by that date, then either shall Notify the other of the impasse. Each party shall within 10 Business Days after the effective date of that Notice designate an Arbitrator, who need not be Disinterested. All appointed Arbitrators shall be MAI appraisers with at least 10 years' experience appraising properties within the market in which the property is located. Those two party-appointed Arbitrators shall within 10 Business Days designate a third Arbitrator, who must be Disinterested. If the two party-appointed Appraisers cannot agree on the appointment of a Disinterested Arbitrator, they shall apply to the AAA or any successor organization for the appointment of a Disinterested Arbitrator, but the AAA arbitration rules and procedures will be not be used and instead, the arbitration rules and procedures set forth in this Lease shall govern. The Arbitrators shall hold

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2 We omit possible details about the definition of Land Value, as this program relates to arbitration, not the nuances of Land Value

3 Alternatively, the parties can agree to the appointment of Appraisers for an appraisal proceeding. In an appraisal proceeding, the parties are not entitled to an arbitration hearing, and do not have the right to present witnesses or evidence or be represented by counsel, all of which they are entitled to in an arbitration. A Land Value determination by Appraisers will work about the same as the arbitration procedures described in text, substituting appraisers for arbitrators.

hearings within [90 days] of the appointed of the Disinterested Arbitrator. All three Arbitrators must agree in writing to determine Land Value in good faith in accordance with this Article. The Disinterested Aribtrator shall select the Final Fair Market Value Determination of either Landlord or Tenant that the Disinterested Arbitrator believes is closest to Fair Market Value, and nay not select any other amount as the Fair Market Value. The parties shall confirm that selected Fair Market Value in writing.

1.4. *Failure to Designate.* If either party fails to timely designate an Arbitrator, and does not cure that failure within 10 Business Days after Notice from the other party, which Notice states in capital text "**FAILURE TO TIMELY DESIGNATE AN ARBITRATOR SHALL RESULT IN FORFEITURE OF THE RIGHT TO NAME AN ARBITRATOR AND AN ARBITRATOR SHALL BE APPOINTED ON YOUR BEHALF**," then the one designated Arbitrator shall appoint the Arbitrator for the other party.

1.5. *Delegation.* Landlord and Tenant may each, by Notice to the other, delegate to one Mortgagee all its rights under this paragraph. That delegation shall: (i) bind the recipient of the delegation Notice; and (ii) remain effective until the designated Mortgagee has either satisfied and discharged its Mortgage of record or given Notice terminating the delegation.

1.6. *Disinterested.* "Disinterested" means collectively, (i) having no economic interest, direct or indirect, in the Land, the Improvements, or any property or business owned in whole or in part by Landlord or Tenant; (ii) not being a partner of, or employed by the same firm as, any nominee selected by Landlord or Tenant; (iii) not being an officer, director, employee, partner, manager, member, shareholder, or other similarly positioned individual of Landlord, Tenant, or any Affiliate of either at the time in question or any time within the previous five years; (iv) not having been an agent or adviser of Landlord, Tenant, or an Affiliate of either in those five years; and (v) not being related, within six degrees of consanguinity, to anyone listed in clauses (i) through (iv).[4]

2. LAND VALUE ARBITRATION (OPTION 2)

Experienced litigators tend to prefer JAMS arbitration over AAA arbitration except for valuation disputes, where AAA typically has a better roster of appraisers. The AAA rules are, however, often regarded as cumbersome and the administration process can be extremely slow.

Here is an example of arbitration procedures for a fair market value determination:

2.1. *Initial Meeting.* Within 30 days after the appointment of the third arbitrator, the three arbitrators will meet (the "Initial Meeting") and set a hearing date for the arbitration. The hearing shall not exceed five days and shall be scheduled to be held within [90/120] days after

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[4] This sets a rather high standard, perhaps an unrealistic one, if Landlord or Tenant is a major player or even a somewhat active player.

the meeting of the three arbitrators. At the Initial Meeting, Landlord and Tenant shall each submit a Fair Market Value determination (each, a "Final Determination"). If either party shall fail so to submit a Final Determination, then the other party's Final Determination shall be selected as the Fair Market Value.

2.2. *Arbitration Procedures.* There shall be no discovery in the arbitration. [For space leases: However, on reasonable notice to the other party, Tenant may inspect any portion of the Building relevant to its claims, and Landlord may inspect any portion of the space occupied by Tenant on the floors in issue.] The Disinterested Arbitrator shall establish a schedule prior to the scheduled hearing for the parties to exchange opening written expert reports and opening written pre-hearing statements, rebuttal written expert reports and rebuttal written pre-hearing statements, exchange of written witness lists, including a brief statement as to the subject matter to be covered in the witnesses' testimony, and to exchange all documents that they intend to offer at the hearing. Other than rebuttal witnesses, only the witnesses listed on the witness lists shall be allowed to testify at the hearings. Each party may present live witnesses and offer exhibits, and all witnesses shall be subject to cross-examination. The Arbitrators shall conduct the five day hearing so as to provide each party with sufficient time to present its case, both on direct and on rebuttal, and permit each party appropriate time for cross examination; provided, that the arbitrators shall not extend the hearing beyond five days. Each party may, during its direct case, present evidence in support of its position and in opposition to the position of the opposing party.

2.3. *Decision.* Following the conclusion of the hearings, the three Arbitrators shall meet and within 10 Business Days following the conclusion of the hearings, the Disinterested Arbitrator shall make a determination of the Fair Market Value by selecting either the amount set forth in Landlord's Final Determination or the amount set forth in Tenant's Final Determination, whichever the third arbitrator determines is closest to Fair Market Value of the Land, and may not select any other amount as the Fair Market Rent, provided that in no event shall the rent be less than the Annual Rent. The Disinterested Arbitrator need not issue a "reasoned award" or any explanation of his or her determination. The fees and expenses of any arbitration pursuant to this Section shall be borne by the parties equally, but each party shall bear the expense of its own arbitrator, attorneys and experts and the additional expenses of presenting its own proof. The arbitrators shall not have the power to add to, modify or change any of the provisions of this Lease. After a determination has been made of the Fair Market Value, the parties shall execute and deliver an instrument setting forth the rent based on the Fair Market Value, but the failure to so execute and deliver any such instrument shall not effect the determination of the rent based on Fair Market Value.

3. GENERAL ARBITRATION LANGUAGE (NOT SPECIFIC TO FAIR MARKET VALUE)

3.1. *Use of Arbitration.* Only where this Lease states that any disagreement or impasse shall be resolved through Arbitration (an "Arbitrable Matter"), that Arbitrable Matter, including the scope of any Arbitrable Matter and whether an asserted Arbitrable Matter in fact qualifies as such, shall be determined by arbitration in New York City before one arbitrator ("Arbitration"). The Arbitration shall be administered by JAMS Alternative Dispute Resolution Services in the City of New York (with any successor organization, "JAMS") under its Streamlined Arbitration

Rules & Procedures, effective July 1, 2014, as amended. [JAMS Rule 28 (baseball arbitration) shall apply

3.2. *Procedural Matters.*In any Arbitration: (a) the arbitrator shall have no right to award damages on account of any unreasonable or allegedly unreasonable withholding of any consent where that withholding is an Arbitrable Matter; and (b) the decision and award of the arbitrator shall be final and conclusive on the parties. The parties consent to entry of judgment based on that award. The party whose position the Arbitrator rejected shall pay all costs and fees, including reasonable attorneys' fees, of both parties in the Arbitration unless the Arbitrator finds that neither party prevailed.[5] The Arbitration shall be confidential. The parties shall preserve its confidentiality. Except as this Lease states, the Arbitrator shall establish the Arbitration rules of procedure. If any party fails to appear at a duly scheduled and noticed hearing, the arbitrator is hereby expressly authorized to enter an award for the appearing party. This Arbitration clause shall not preclude anyone from seeking provisional remedies in aid of Arbitration from a court. If JAMS (and any successor organization) no longer exists, then Landlord shall reasonably designate a replacement.

4. ARBITRATION FOR DISPUTES ON FORM OF DOCUMENTS

4.1. *Efforts to Agree.* Landlord and Tenant shall use commercially reasonable efforts to agree on a final form of the Documents, on or before [DATE] (the "**Arbitration Date**").

4.2. *Submission of Dispute.* If the final form of the Documents is not agreed to by both parties on or prior to the Arbitration Date, either party shall submit a dispute relating to the documentation that has not been finalized to final and binding arbitration in New York, New York administered by JAMS in accordance with JAMS Streamlined Arbitration Rules and Procedures in effect at that time (or, if JAMS is no longer in existence, then administered by National Arbitration and Mediation ("**NAM**"), in accordance with NAM's Comprehensive Dispute Resolution Rules and Procedures; and if NAM is no longer in existence, then administered by any successor or substantially similar dispute resolution organization). A single arbitrator will be selected pursuant to such rules and procedures (the "**JAMS Arbitrator**").

4.3. *Arbitration Procedure.* The parties agree that: (1) the unsuccessful party in such arbitration will pay to the successful party all reasonable attorneys' fees and disbursements incurred by the successful party in connection with such arbitration, and will pay any fees and disbursements due to JAMS (or the organization administering the arbitration) and the JAMS Arbitrator and, to the extent the "successful" party cannot be clearly identified, each party will bear its own costs and expenses and the parties will pay their equal share of any fees and disbursements due to JAMS (or the organization administering the arbitration) and the JAMS Arbitrator; (2) arbitration pursuant to this Section is intended to be the sole and exclusive method of arbitration to be utilized by the parties and the sole and exclusive dispute resolution method to

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5 Clients often have strong views on attorneys' fees clauses.

be utilized by the parties concerning any dispute regarding the final form of the Documents; (3) the JAMS Arbitrator shall have no right to award damages; (4) Landlord and Tenant shall submit to such binding arbitration only the terms and conditions of the relevant documents as to which there is a dispute (the "**Disputed Terms**") and all terms and conditions of the relevant documents not submitted to arbitration (the "**Undisputed Terms**") shall be deemed to be irrevocably agreed upon by Landlord and Tenant, (5) the JAMS Arbitrator shall follow the [provisions of the Term Sheet [or other document governing the purpose of the disputed documents][6], and (6) any decision or award rendered in such arbitration, whether or not such decision or award has been confirmed, shall be final and binding upon Landlord and Tenant and shall constitute an "award" by the JAMS Arbitrator within the meaning of the applicable arbitration rules and Laws. Each party shall submit to the JAMS arbitrator, with respect to each Disputed Term, the language proposed by such party for the Disputed Term (the "Proposed Term"). The JAMS Arbitrator shall determine the Disputed Terms on an issue by issue basis, and shall order, with respect to each Disputed Term, that the parties enter into the Proposed Term submitted by either Landlord or Tenant as to that specific issue, and shall not modify the Proposed Term submitted by the prevailing party as to such issues.

4.4. *Limitations.* The JAMS Arbitrator will be bound by the provisions of this Lease and will not have the power to add to, subtract from or otherwise modify such provisions or any of the Undisputed Terms. The JAMS Arbitrator will consider only the specific Disputed Terms submitted to him/her for resolution, and will be directed to make a determination as to the "successful" party or a specific determination that there is no prevailing party. If any party fails to appear at a duly scheduled and noticed hearing, the JAMS Arbitrator is hereby expressly authorized to enter judgment for the appearing party. The JAMS Arbitrator need not issue a "reasoned award" or provide an explanation of his/her decision. Landlord and Tenant shall each have the right to appear and be represented by counsel before the JAMS Arbitrator and to submit such data and memoranda in support of their respective positions in the matter in dispute as may be reasonably necessary or appropriate under the circumstances. Neither party shall have ex parte communications with any arbitrator selected under this Section [__] following his or her selection and pending completion of the arbitration hereunder.

4.5. *Arbitrator Standards.* Any JAMS Arbitrator acting under this Section [__] shall (1) be experienced in the field to which the dispute relates, (2) have been actively engaged in such field for a period of at least 10 years before the date of his or her appointment as a JAMS Arbitrator hereunder, (3) be sworn fairly and impartially to perform his or her respective duties as a JAMS Arbitrator hereunder, (4) not be an employee or past employee of Landlord or Tenant or of any other person, partnership, corporation or other form of business or legal association or entity that controls, is controlled by or is under common control with Landlord or Tenant and (5) never have represented or been retained for any reason whatsoever by Landlord or Tenant or any

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[6] If no such document exists, the Lease should state the standards the Arbitrator should apply in choosing between the parties' submissions.

other person, partnership, corporation or other form of business or legal association or entity that controls, is controlled by or is under common control with Landlord or Tenant.

4.6. *Cooperation.* Landlord and Tenant agree to sign all documents and to do all other things necessary to submit any such matter to arbitration and further agree to, and hereby do, waive any and all rights they or either of them may at any time have to revoke their agreement to submit to arbitration and to abide by the decision rendered.

Topic II

Work Letters or What Leasing Lawyers Need to Know About Design and Construction Agreements

By

Keith Reich, Esq.

WORK LETTERS OR WHAT LEASING LAWYERS NEED TO KNOW ABOUT DESIGN AND CONSTRUCTION AGREEMENTS

By

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I. WHAT IS A WORK LETTER

1. Purpose of Work Letters

    (a) vs. "as-is

    (b) Describes Landlord's Work

    (c) Triggers Commencement Date, i.e., substantial completion of Landlord's Work

    (d) Sometimes describes procedures for approving Tenant's Work, particularly if Landlord will be performing Tenant's Work

2. Types of Work Letters

    (a) Simple narrative, i.e., detailed scope of work

    (b) Plans and specifications – Complete set of construction drawings

    (c) Plans and specifications – To be prepared

    (d) For existing building

    (e) For new construction/major renovation

3. Difference between a Work Letter and an Alterations provision

II. DESCRIPTION OF LANDLORD'S WORK

1. Scope of Work/Narrative – Issues, e.g., lack of specificity and detail

2. Plans and specifications to be prepared by Landlord

    (a) Based on scope of work, preliminary drawings, etc.

    (b) Mechanism for preparation, submission to Tenant, approval/rejection by Tenant, etc. – time periods, basis for approval/rejection, deemed approval, etc.

3. Complete set of plans and specifications as a Lease exhibit

4. Modification of plans and specifications after completed/approved

   (a) By Landlord, e.g., requirements of law, field conditions, errors & omissions

   (b) By Tenant, e.g., changes to accommodate Tenant's installations

III. SUBSTANTIAL COMPLETION

1. Definition – Exclude long lead items, items that shouldn't be completed until after completion of Tenant's Work, accelerate substantial completion date/commencement date for Tenant Delays for purposes of rent commencement (but not for satisfying Landlord's obligation to complete Landlord's Work), certification by Landlord's architect and/or by Tenant's architect, etc.

2. Notice of Substantial Completion – Timing (before or upon actual substantial completion), preliminary notice, conclusive and binding notice;

   (a) Punch-List – Notice, Landlord's obligation to complete, time period for completion, coordination with performance of Tenant's Work, etc.

   (b) Exceptions to Tenant's acceptance of substantial completion (or for an "as-is" provision - Latent defects, seasonal issues, Landlord's ongoing maintenance and repair obligations

3. Disputes – Time period for inspection and notice of dispute, resolution of disputes (e.g., expedited arbitration, one arbitrator from pre-approved list, prevailing party attorneys' fees)

4. Other Conditions for Substantial Completion/Trigger of Commencement Date - Premises to be in legal compliance (including ADA for Landlord's Work), Premises to be broom-clean, vacant, etc., Building systems in good working order, no violations that would delay Tenant's Work or use of Premises

   (a) For New Construction - Removal of scaffolding, hoists, construction shanties, etc., Building/common areas in legal compliance, including ADA

   (b) Rights of Re-measurement for new construction

5. Late Delivery – Preliminary Outside date; final Outside Date, damages and right of termination

   (a) Tenant delays - notice requirement

   (b) Force majeure - limitation on period

   (c) Reimbursement of expenses

   (d) Self-help right

(e) Landlord right of termination

IV. PRE-COMMENCEMENT ACTIVITIES

1. Doesn't trigger Commencement Date

2. Interference with Landlord's Work - Priority for freight elevator, loading dock, hoists, etc., Tenant Delay]

V. OTHER LANDLORD'S WORK ISSUES/NEW CONSTRUCTION/WORK LETTER

1. Appoint construction representatives - to give notices, attend meetings, etc.

2. Require attendance at regular construction meetings

3. Benchmark/Milestone Dates - construction loan closing, building permits, demolition, excavation/foundations, Building skin, topping off, etc.

4. Separate sign-off for "substantial completion" of each item of Landlord's Work

5. Partial delivery of multi-floor premises

VI. TENANT'S WORK

1. Different procedure/time period for submission/approval of Tenant's plans

   (a) No approval – cosmetic/decorative; below certain dollar amount (CPI adjustment); no requirement of governmental approval or plan submission

   (b) No deemed approval for structural alterations

   (c) Reasonable approval – non-structural; no (adverse) impact on Building systems; limited to interior

   (d) Sole discretion – structural; impact on Building systems; outside the Premises

      (i) Exceptions to sole discretion – minor core drilling; supplemental hvac, generators, rooftop equipment, internal staircases, etc.

   (e) Pre-approval of plans/scope of work

2. Providing Building services

   (a) After Commencement Date, subject to completion of Tenant Work - distribution of electrical work, plumbing, hvac ducts

(b) Temporary services during Tenant's Work - electricity, a/c in summer for millwork, toilets, etc.

3. Tenant Improvement Allowance

(a) Tenant performing Tenant's Work vs. Landlord performing Tenant's Work

(b) Soft-cost; ff&e

(c) No Tenant default/cure default

(d) Upfront payment vs. progress payments vs. payment upon substantial completion

(e) Tenant's money first vs. Landlord's money first vs. pari passu

(f) Timing of payments/conditions to payments - paid vs. unpaid invoices, lien waivers/in lieu of lien waivers, certificates of architects, inspections, etc.]

(g) Retainage/reduction of retainage

(h) Final payment/conditions

(i) Time period to use allowance

(j) Unused allowance

(k) Landlord's failure to fund - offset rights, limitation on amount of monthly deductions, right to dispute, interest

4. If performed by Landlord with Landlord's Work

(a) Timetable for submission of plans and specifications and revisions (if applicable)

(b) Change orders

(c) Requirement to bid

5. If performed by Tenant

(a) Union vs. non-union

(b) Noise/construction during business hours

(c) Use of freight elevator/loading dock

(i) Staging of materials - sidewalk, interference with access and other tenants

(ii) Minimum required hours

(iii) Free after-hours use

(d) Approval of contractors - pre-approval, reasonable approval, deemed approval, reasons for disapproval, e.g., bankruptcy, problems in Building or other Landlord affiliate owned buildings, felony convictions

6. Additional security for Tenant's Work/Alterations - l/c, guaranty, threshold amount (subject to CPI adjustment), net worth test

7. Cooperation of Landlord

(a) Execute permit applications - including prior to plan submission and approval

(b) Access to Building plans

(c) Access to other portions of Building/other tenant space

(d) Use of Landlord's hoist/right to install Tenant hoist (new construction)

8. After completion of Tenant's Work/Alterations

(a) Close permits

(b) Sign-offs

(c) As-built plans

(d) No liens, violations, etc.

VII. MISCELLANEOUS ISSUES

1. Exceptions in SNDA for completing Landlord's Work, funding TI allowance, permitting offsets

2. Landlord security/guaranties

3. No sale of Building until construction is completed and fully operational

Topic III

Economics of the Deal

These Materials are available online

www.CommercialRealEstate18/

By

Eric G. Menkes, Esq.

Topic IV

Omni-Channel Leasing

These Materials are available online

www.CommercialRealEstate18/

By
Nina Kampler, Esq.

Topic V

Representing the Not-For-Profit Entity in Leasing

By

Andrew Herz, Esq.
and
Hope Plasha, Esq.

REPRESENTING NOT-FOR-PROFIT TENANTS IN LEASING TRANSACTIONS

Andrew L. Herz
Hope K. Plasha
Patterson Belknap Webb & Tyler LLP

October 10, 2018

I. **<u>The Client</u>**

A. **How are not-for-profit clients different?**

1. Real estate is not their core business.

2. Generally, they lack real estate expertise.

3. May be eternal optimists and naïve as to costs.

4. Are subject to greater regulatory and community scrutiny.

5. Board members may hold differing opinions regarding the merits of a project.

B. **How is the leasing process different?**

1. Often they underestimate the time required from the start-up of their space search to move-in and do not plan for the possibility of construction delays.

2. Often they underestimate the amount of staff personnel involvement required.

3. Frequently they do not realize the disruption to their organization.

4. They may underestimate the cost to their organization – especially with regard to tenant buildout and IT.

5. Need to build in time for, and process to obtain, consent of Board.

6. May think use of a board-connected broker or attorney is an easier path.

C. **How are their needs different?**

1. May need governmental approvals – medical, education.

2. May be dependent on irregular governmental and foundation support (and such support may be conditioned in various ways, including real property requirements).

3. Accounting for leases (especially after 2020) may be different.

4. May require that physical changes be made to space to comply with law – Article 28, HIPPA.

5. Exemption from real estate taxes if owner is exempt.

6. Potential exemption from sales tax on construction they undertake for their own benefit.

7. May need separate entrance if have client visitations and/or separate elevators and path of travel (particularly for children).

8. May be attractive as a user of designated "community facility space."

9. Need to be attentive to political and community support for major projects given stakeholder relationships.

II. **Customary Lease Provisions Which May Affect Not-for-Profits Differently.**

1. Permitted use – may define too narrowly – need for flexibility.

2. Cancellation rights – especially if dependent upon government funding or grants.

3. Assignment and subletting – need for transfers to successors and affiliates – stock ownership can't be the test. Net worth tests also do not work.

4. Need to expand and shrink space.

5. Space-sharing with coordinated organizations.

6. Management of costs of buildout and tenant improvement allowances – including landlord fees and holdover expenses at existing space.

7. Costs of services – especially overtime usage.

8. Security deposit – need for flexibility – need for burndown – letter of credit.

9. Renewal rights – especially if large buildout cost.

10. Parking – especially handicapped.

11. Programmatic Requirements (*e.g.*, playgrounds for schools, laboratory and clinical spaces for medical providers).

12. Wish list –

a. green building requirements

b. air quality standards

c. bicycle parking

d. terraces

13. Signage needs.

III. <u>Leasehold Condo</u>

1. New York City has taken position that if have 30+ year leasehold, tenant can create leasehold condominium and be exempt from real estate taxes.

2. Need landlord buy-in.

3. Cost and timing.

REPRESENTING NOT-FOR-PROFIT TENANTS IN LEASING TRANSACTIONS

Andrew L. Herz
Hope K. Plasha
Patterson Belknap Webb & Tyler LLP

October 10, 2018

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Topic V

Leasing Issues for Tax Exempt Entities

By

Sunjata Yalamanchili, Esq.

Leasing Issues for Tax Exempt Entities

Under the NY Not-for-Profit Corporations Law (N-PCL), an entity may qualify as either a charitable or non-charitable not-for-profit corporation if the ordinary purpose of the corporation is not for pecuniary profit or financial gain. (NY Not-for-Profit Corp. L. § 102 (McKinney)). An entity may qualify as a religious corporation under the NY Religious Corporations Law if created primarily for religious purposes. (NY Relig. Corp. L. § 2 (McKinney)). If a registered not-for-profit corporation or a religious corporation seeks to enter a real property lease as a landlord, the corporation must abide by a particular set of requirements.

The NY Not-for-Profit Corporations Law and NY Religious Corporations Law govern these situations. A good starting point considers whether the entity is registered as a not-for-profit corporation or a religious corporation, as some requirements differ between each entity. The requirements also differ depending on whether the entity is leasing out property it owns (acting as a landlord), or looking to lease property for its own use (acting as lessee).

A. Not-for-Profit Corporation

Authorization

Section 509(b) of the Not-for-Profit Corporations Law states that "[n]o corporation shall sell, mortgage, lease, exchange or otherwise dispose of its real property unless authorized by the vote of a majority of directors of the board or of a majority of a committee authorized by the board . . . ." So, in order to lease property to a tenant, a not-for-profit entity must obtain authorization for the transaction from its board of directors. For an isolated transaction involving real property, the entity must obtain authorization by "the vote of a majority of directors of the board or of a majority of a committee authorized by the board." (§ 509(b)). However, if the transaction involves "*all, or substantially all*, of the assets of the corporation," the entity must obtain authorization by two-thirds of the entire board or, if there are twenty-one or more members, authorization by the vote of a majority. (§ 509(b) (emphasis added)). Each entity's bylaws may provide further voting requirements. If the not-for-profit is leasing property for its own benefit, board approval is not required, although it may be obtained as a precaution.

For a transaction involving all or substantially all of a non-charitable corporation's assets, the board must adopt a resolution specifying "terms and conditions of the proposed transaction, including the consideration to be received by the corporation and the eventual disposition to be made of such consideration, together with a statement that the dissolution of the corporation is or is not contemplated thereafter." (§ 510(a)(1)). If the board passes the resolution, the corporation's members (if any) must subsequently approve it. The members may approve the transaction as specified in the board's resolution, or the members may approve the transaction while authorizing the board to modify the terms and conditions of the transaction. (§ 510(a)(1)).

Approval

On the other hand, a charitable corporation (a Type B, Type C, or Type D with charitable purposes), must not only obtain board and member approval for a sale or lease of real property constituting all or substantially all of its assets, but "shall **in addition require approval of the attorney general or the supreme court** in the judicial district or of the county court of the county in which the corporation has its office or principal place of carrying out the purposes for which it was formed . . . ." (§ 510(a)(3)).

To obtain Attorney General (AG) review under N-PCL § 511-a:

1. Corporation submits a draft petition to the AG before submission to the court, allowing the AG to perform a preliminary compliance review (note, this is not available to insolvent corporations)
2. The AG may require additional information while reviewing the petition
3. The AG can approve the transaction by writing "Attorney General's Approval" on the petition

Note – this method is preferred by the Charities Bureau.

To obtain Court approval, with notice to the AG under N-PCL § 511:

1. Corporation files a verified petition with the court
2. Corporation must give AG at least 15 days' notice before a hearing on the petition
3. The AG will grant a "no objection" endorsement on the petition if it complies with all requirements, or the AG may require the corporation to give notice to interested parties and have a hearing before the court

Both the court and the AG apply the same standard of review when evaluating a not-for-profit corporation's proposed transaction. The court and AG consider two prongs:

1. Whether the terms of the transaction are fair and reasonable to the corporation, and
    a. Valuation: while not explicitly required by the Not-for-Profit law, case law suggests that an independent appraiser should value the property using at least three comparable sales.
    b. Conflicts of Interest: the court and AG consider whether an officer, director, member, employee, or other party has an interest in the transaction
2. Whether the transaction serves the purpose of the corporation or its members.
    a. Proceeds: any proceeds obtained from the transaction must be distributed or allocated according to the corporation's charitable purpose; they cannot be used to benefit a particular director, officer, member, etc.

Transactions involving interested parties, such as directors, officers, or members, must comply with additional requirements as stated in N-PCL § 715.

B. Religious Corporations

Authorization

Like not-for-profit corporations, the board and members of religious corporations must authorize the transaction. However, a particular religious sect may have specific quorum requirements stated in the Religious Corporations Law (for example, RCL § 134 lists requirements for corporate meetings held by Baptist Churches).

Approval

Section 12 NY Religious Corporation Law provides that "a religious corporation shall not sell, mortgage or lease for a term exceeding five years any of its real property without applying for and obtaining leave of the court or the attorney general therefore . . ." pursuant to the requirements in N-PCL § 511 and § 511-a. A specific list of churches are only required to seek court approval, and need not notify the AG. Unlike for not-for-profit corporations, court or AG approval is required *even if* the property does not constitute all or substantially all of the religious corporation's assets. Purchase money mortgages and purchase money security agreements do not require court or AG approval.

The court and AG apply the same two-prong test to both religious corporations and not-for-profit corporations: whether the transaction is fair and reasonable and whether it serves the purpose of the religious corporation or its members. (N-PCL §§ 511(d), 511-a(c)). While most religious entities should obtain an appraisal to demonstrate the fairness of the transaction, a solvent religious corporation seeking to convey property to "another religious corporation, or to a membership, educational, municipal or other non-profit corporation" need not obtain an appraisal if the transaction is for nominal consideration. (RCL § 12(8)).

C. Other Considerations

Attorneys should be aware that several issues may arise when a not-for-profit or religious corporation engages in a real property transaction. These issues include:

1. Tax implications – such as private benefit and private inurement rules; may also incur penalties under the IRS and New York State
2. Conflicts of interest – such as when a board member or director has a financial stake in the transaction
3. Particularized requirements for public versus private charities – such as self-dealing and excess benefit transactions
4. Unrelated Taxable Business Income (UBIT)

Summary:

Entity Type	Applicable Law	Board approval required to act as landlord?	Court or AG approval required to act as landlord?	Board approval required enter lease as lessee?
Not-for-Profit Corporation: *non-charitable purpose*	NY N-PCL §§ 509–511-a	Yes	No	No*
Not-for-Profit Corporation: Type B, Type C, or Type D corporation with *charitable purpose*	NY N-PCL §§ 509–511-a	Yes	Yes, if transaction involves "all or substantially all" of corporation's assets	No*
Religious Corporation	NY RCL § 12 NY N-PCL §§ 509–511-a	Yes	Yes, regardless of size of assets* (but – leases for less than a 5-year term do not require approval)	No*

*Bylaws of the individual entities may impose additional requirements.

Topic V

Implications of Sale Leaseback Transactions

By

Sunjata Yalamanchili, Esq.

Implications of Sale-Leaseback Transactions

Background

A sale-leaseback occurs when one party sells property to a buyer, who then leases the property back to the seller. Although this arrangement occurs in a single transaction, it creates a relationship between the seller/tenant and buyer/landlord that extends beyond the initial sale of the property. Parties should craft sale-leaseback transactions with the tax implications and future relationships in mind.

Tax Implications

A. Benefits of a Sale-Leaseback Transaction

1. Tax Benefits for Seller/Tenant – tenants may deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. (26 U.S.C. § 162 (a)(3) (2012)).
2. Tax Benefits for Buyer/Landlord – buyer/landlord can take a depreciation deduction, and if the property is financed, the buyer/landlord may be able to deduct the loan's interest. (26 U.S.C. §§ 163, 167, 168 (2012)).
3. Liquidity – seller/tenant can put cash from the purchase price toward other investments
4. Value & Rate of Return – buyer/landlord can add investment property to its portfolio that generally performs at a predictable, high rate of return
5. Financing – parties have freedom to structure financing and options to purchase or extend

B. Drawbacks of a Sale-Leaseback Transaction

1. Disqualified Transaction – the IRS may interpret the sale-leaseback transaction as an attempt to avoid federal income tax. In such a case, the seller/tenant will have to evaluate taxable income based on the constant rental accrual rate of the property.
2. Like-kind Exchange – parties cannot recognize a gain or loss a transaction involving the exchange of a lease in real estate for 30 years or more for a fee interest in real estate. (26 U.S.C. § 1031(a); 26 C.F.R. 1.103 (2018)).
3. Financing Transaction – the IRS may find that the buyer/landlord is actually making a loan to the seller/tenant, and therefore prohibits the seller/tenant from taking rental deductions, prohibits the buyer/landlord from reporting income in the form of rental payments, and reallocates the depreciation deduction to the seller/tenant. (*See, e.g., Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939)).
4. Double Transfer Taxation – parties may be required to pay transfer tax on the sale of property and on the subsequent leasehold interest. (20 N.Y.C.R.R. § 575.7 (2018)).

C. Avoiding Problems with a Sale-Leaseback Transaction: Economic Substance

Depending on how the parties structure the sale-leaseback transaction, the IRS and/or the courts may require the parties to forgo important tax deductions. If so, neither party may receive the benefit of its bargain.

The IRS and the courts typically view sale-leaseback transactions as a whole, rather than simply considering the form of the transaction. Therefore, parties structuring a sale-leaseback transaction should do so carefully to avoid unintended tax consequences. If a transaction is an arms-length transaction, is "not shaped solely by tax-avoidance features that have meaningless labels attached," and the "lessor retains significant and genuine attributes of traditional lessor status," the IRS or court may find that the transaction has sufficient economic substance. (*Frank Lyon Co. v. U.S.*, 435 U.S. 561, 583–84 (1978)). The parties should ensure that the purpose of the transaction extends beyond simply avoiding paying higher income taxes on the property.

Protecting the Parties' Relationship

A. Loss of Flexibility

The seller's relationship with the property changes significantly upon the sale and subsequent lease of the property, as the seller/tenant loses some aspects of control. The buyer/landlord may impose restrictions or covenants on the land that the seller/tenant must follow. Additionally, the parties should consider either party's rights with respect to terminating, assigning, or subletting the lease, and whether the seller/tenant has an option to purchase the property or extend the lease upon expiration of the lease term.

B. Classification of Lease

The seller/tenant and buyer/landlord typically enter into triple net leases, where the seller/tenant pays property taxes, insurance, and maintains the property. As investment property, the buyer/landlord has an interest in the property's upkeep. The parties should agree on the scope of these responsibilities before entering into the lease.

C. Seller/Tenant's Interest

Because an option to purchase as part of the sale-leaseback may trigger unintended tax consequences, the seller/tenant may not have an ownership interest at the end of the lease term. To protect its interest, the seller/tenant should plan in advance whether it plans to purchase the property for fair market value, extend the lease, or relocate to different premises upon expiration of the lease.

D. Buyer/Landlord’s Bankruptcy

If the buyer/landlord files for bankruptcy, the seller/tenant may lose any rights it had to extend the lease or purchase the property. The seller/tenant may have some protections under bankruptcy law.

Conclusion

Parties considering a sale-leaseback transaction should carefully evaluate the transaction’s benefits and drawbacks. A transaction structured with economic substance and evidence of some purpose beyond simply avoiding federal income taxation lowers each party’s risk. Furthermore, negotiating the scope of the seller/tenant and buyer/landlord relationship before entering into the transaction reduces the likelihood of complications between the parties in the future.

Topic VI

Letters of Credit and Guarantees
And
Case Law

By

Michael P. Reyen, Esq.

Additional Outline Submitted by Bruce J. Leuzzi, Esq.

Available online at:

www.CommercialRealEstate18/

[BANK NAME]

IRREVOCABLE STANDBY LETTER OF CREDIT

LETTER OF CREDIT NO.: (LC NUMBER INSERTED)

DATE: (INSERTED AT TIME OF ISSUANCE), 20__

ISSUING BANK:

ADDRESS:

EXPIRATION DATE:

AMOUNT:

BENEFICIARY:

WE HEREBY ESTABLISH IN YOUR FAVOR OUR IRREVOCABLE LETTER OF CREDIT NO (1c number inserted) IN THE AMOUNT OF _____________________ FOR THE ACCOUNT OF ______________.

DEMANDS FOR PAYMENT UP TO THE MAXIMUM AGGREGATE AMOUNT AVAILABLE UNDER THIS LETTER OF CREDIT SHALL BE PAID BY US AT OR BEFORE 1:00 P.M. PACIFIC TIME ON THE NEXT SUCCEEDING BUSINESS DAY AFTER OUR RECEIPT ON OR PRIOR TO OUR CLOSE OF BUSINESS ON THE EXPIRATION DATE, OF ONE OR MORE DRAFTS IN THE FORM OF ANNEX A HERETO SIGNED BY YOUR AUTHORIZED OFFICER OR REPRESENTATIVE OR, IF THIS LETTER OF CREDIT IS TRANSFERRED, BY AN AUTHORIZED OFFICER OR REPRESENTATIVE OF ANY TRANSFEREE BENEFICIARY. EACH DRAFT DRAWN HEREON SHALL BE ADDRESSED TO US, REFERENCE THIS LETTER OF CREDIT BY NUMBER, SPECIFY THE AMOUNT OF SUCH DRAFT AND OTHERWISE BE IN THE FORM OF ANNEX A HERETO, AND BE PRESENTED TOGETHER WITH THE ORIGINAL LETTER OF CREDIT AND ANY AMENDMENTS, AND BENEFICIARY'S SIGNED STATEMENT BY AN AUTHORIZED REPRESENTATIVE OF BENEFICIARY STATING AS FOLLOWS:

“THE UNDERSIGNED HEREBY CERTIFIES THAT BENEFICIARY IS ENTITLED TO DRAW ON THE LETTER OF CREDIT PURSUANT TO THAT CERTAIN OFFICE LEASE DATED ____________ BY AND BETWEEN _____________ AND ________________, AS IT MAY BE AMENDED OR ASSIGNED FROM TIME TO TIME."

OR

"THE UNDERSIGNED HEREBY CERTIFIES THAT BENEFICIARY HAS RECEIVED A WRITTEN NOTICE OF BANK'S ELECTION NOT TO EXTEND ITS STANDBY LETTER OF CREDIT NO. ___________ AND BENEFICIARY HAS NOT RECEIVED A REPLACEMENT LETTER OF CREDIT WITHIN FORTY FIVE (45) DAYS PRIOR TO THE PRESENT EXPIRATION DATE."

THE LEASE AGREEMENT MENTIONED ABOVE IS FOR IDENTIFICATION PURPOSES ONLY AND IT IS NOT INTENDED THAT SAID LEASE AGREEMENT BE INCORPORATED HEREIN OR FORM PART OF THIS LETTER OF CREDIT.

MULTIPLE DRAWS ARE EXPRESSLY PERMITTED. PARTIAL DRAWINGS ARE ALLOWED. IF YOUR DEMAND REPRESENTS A PARTIAL DRAW, WE WILL ENDORSE THE ORIGINAL LETTER OF CREDIT OF SUCH PAID PARTIAL DRAW AND RETURN THE ORIGINAL LETTER OF CREDIT TO YOU BY OVERNIGHT COURIER SERVICE FOR ANY FUTURE DRAWS.

AS USED IN THIS LETTER OF CREDIT, "BUSINESS DAY" SHALL MEAN ANY DAY OTHER THAN A SATURDAY, SUNDAY OR A DAY ON WHICH BANKING INSTITUTIONS IN THE STATE OF NEW YORK ARE AUTHORIZED OR REQUIRED BY LAW TO CLOSE.

THIS LETTER OF CREDIT SHALL INITIALLY EXPIRE ON ___, 20__. SUCH EXPIRATION DATE SHALL BE AUTOMATICALLY EXTENDED WITHOUT NOTICE OR AMENDMENT FOR PERIODS OF ONE (1) YEAR, BUT IN NO EVENT LATER THAN _______, 20__, UNLESS AT LEAST FORTY FIVE (45) DAYS BEFORE ANY EXPIRATION DATE, WE NOTIFY YOU BY REGISTERED MAIL OR OVERNIGHT COURIER SERVICE AT YOUR ADDRESS ABOVE, THAT THIS LETTER OF CREDIT WILL NOT BE EXTENDED BEYOND THE THEN-CURRENT EXPIRATION DATE. UPON RECEIPT BY YOU OF SUCH NOTIFICATION, YOU MAY DRAW ON THIS LETTER OF CREDIT AS SET FORTH ABOVE, PROVIDED THAT THE AMOUNT OF YOUR DRAW SHALL NOT EXCEED THE TOTAL AMOUNT THEN AVAILABLE FOR PAYMENT HEREUNDER.

DRAW REQUESTS MAY BE SUBMITTED IN PERSON, BY COURIER, OR BY MAIL TO OUR ADDRESS STATED ABOVE.

THIS LETTER OF CREDIT IS TRANSFERABLE ONE OR MORE TIMES IN ITS ENTIRETY UPON OUR RECEIPT OF A TRANSFER REQUEST IN THE FORM ATTACHED AS EXHIBIT B, SIGNED BY THE THEN CURRENT BENEFICIARY. TRANSFER FEES ARE FOR ACCOUNT OF THE APPLICANT.

WE HEREBY ENGAGE WITH YOU THAT ALL SIGHT DRAFTS DRAWN UNDER AND IN COMPLIANCE WITH THE TERMS AND CONDITIONS OF THIS LETTER OF CREDIT SHALL BE DULY HONORED IF PRESENTED FOR PAYMENT AT THE OFFICE OF ______________________ ON OR BEFORE THE EXPIRATION DATE OF THIS LETTER OF CREDIT.

THIS STANDBY LETTER OF CREDIT IS SUBJECT TO THE UNIFORM CUSTOMS AND PRACTICES FOR DOCUMENTARY CREDITS, 2007 REVISION (ICC PUBLICATION NO. 600 AND ANY SUBSEQUENT REVISION THEREOF) EXCEPT TO THE EXTENT THE SAME WOULD BE INCONSISTENT WITH THE EXPRESS PROVISIONS HEREOF. WE HEREBY WAIVE AND DISCLAIM RIGHTS OF SUBROGATION IN RESPECT OF ANY DRAW MADE BY YOU, WHETHER ARISING UNDER THE UNIFORM COMMERCIAL CODE OR OTHERWISE.

____
AUTHORIZED OFFICER

____
AUTHORIZED OFFICER

ABOVE WORDING APPROVED FOR ISSUANCE OF STANDBY LETTER OF CREDIT
________________________ AUTHORIZED SIGNATURE, _______________

THIS ANNEX A IS AN INTEGRAL PART OF CITY NATIONAL BANK IRREVOCABLE STANDBY LETTER OF CREDIT NO.

ANNEX A

Form of
SIGHT DRAFT

DATE: ______________________________________ REF. NO. ________________________

AT SIGHT

PAY TO THE ORDER OF ____
US$_______________________

US DOLLARS

____

"DRAWN UNDER ________________ BANK, IRREVOCABLE STANDBY LETTER OF CREDIT NUMBER NO. ___________________________ DATED ____________, 20___"

TO:

(INSERT NAME OF BENEFICIARY)

____
AUTHORIZED SIGNATURE

NOTE: BENEFICIARY'S NAME SHOULD BE PRINTED AT THE BACK OF THE SIGHT DRAFT WITH ENDORSEMENT.

EXHIBIT 'B'

THIS EXHIBIT B IS AN INTEGRAL PART OF ____________ BANK IRREVOCABLE STANDBY LETTER OF CREDIT NO.

TRANSFER INSTRUCTIONS FORM

TO: DATE:

RE: ___________ Bank Letter of Credit No. ______________, Dated ____________________

Ladies/Gentlemen:

For value received, the undersigned beneficiary hereby irrevocably transfers to:

(Name of Transferee)
(Address of Transferee)

all rights of the undersigned beneficiary to draw under the above-referenced Letter of Credit in its entirety.

By this transfer, all rights of the undersigned beneficiary in such Letter of Credit are transferred to the transferee and the transferee shall have the sole rights as beneficiary thereof, including sole rights relating to any amendments whether increases or extensions or other amendments and whether now existing or hereafter made. All amendments are to be advised direct to the transferee without necessity of any consent of or notice to the undersigned beneficiary.

The original of the Letter of Credit is returned herewith together with any and all amendments, and we ask you to endorse the transfer on the reverse of the Letter of Credit, and forward it direct to the transferee with your customary notice of transfer.

Beneficiary name:

____
Authorized Signature:

____
Name of signer:

____
Title of signer:

Signature Guaranteed
The beneficiary's signature with title conforms with that on file with us and as such is authorized for the execution of this document.

____
Name of Bank:

____
Authorized Signature:

____
Name of signer:

____
Title of signer:

____
Telephone number:

41 B.R. 398
United States Bankruptcy Court,
S.D. New York.

In re ELEGANT MERCHANDISING, INC.,
Debtor.
ELEGANT MERCHANDISING, INC., Plaintiff,
v.
REPUBLIC NATIONAL BANK and Bank Leumi
Trust Company of New York, Defendants.

Bankruptcy No. 84 B 10903 (HCB).
|
Adv. No. 84 6014A.
|
Aug. 30, 1984.

Synopsis
By order to show cause and application, debtor sought to enjoin one bank from demanding payment or performance from other bank under other bank's letter of credit and to enjoin other bank from honoring demands for payments or performance under letter of credit. The Bankruptcy Court, Edward J. Ryan, J., held that: (1) there was no proper legal authority under which either bank could be enjoined from exercising their respective rights and obligations under letter of credit, and (2) first bank was not entitled to attorney fees.

Application denied.

West Headnotes (4)

[1] **Finance, Banking, and Credit**
Letters of credit

There was no proper legal authority under which one bank could be enjoined from demanding payment or performance from other bank under its letter of credit or other bank could be enjoined from honoring demands for payments or performance under letter of credit.

1 Cases that cite this headnote

[2] **Bankruptcy**
Proceedings, Acts, or Persons Affected
Bankruptcy
Letters of credit

Letter of credit and its proceeds are not "property of the estate," and therefore, payment of letter of credit is not transfer of assets in violation of automatic stay. Bankr.Code, 11 U.S.C.A. §§ 362, 541.

6 Cases that cite this headnote

[3] **Finance, Banking, and Credit**
Letters of Credit

Letter of credit and its proceeds constitute property of bank.

4 Cases that cite this headnote

[4] **Bankruptcy**
Frivolity or bad faith; sanctions

Debtor's application to enjoin one bank from demanding payment or performance from other bank under other bank's letter of credit and to enjoin other bank from honoring demands for payments or performance under letter of credit was filed in good faith, and therefore first bank was not entitled to attorney fees. Fed.Rules Civ.Proc.Rule 11, 28 U.S.C.A.

2 Cases that cite this headnote

Attorneys and Law Firms

***399** Lester A. Lazarus, P.C., New York City, for debtor-plaintiff.

Kreindler & Relkin, P.C., New York City, for defendant

Republic National Bank.

Hahn & Hessen, New York City, for Bank of Leumi Trust Company of New York.

Opinion

EDWARD J. RYAN, Bankruptcy Judge.

On June 8, 1984, Elegant Merchandising, Inc. filed a voluntary petition under Chapter 11 of the Bankruptcy Code (Code). 11 U.S.C. 1101 *et seq.*

On July 24, 1984, by order to show cause and application, the debtor sought to enjoin Republic National Bank of New York (Republic) from demanding payment or performance from Bank Leumi Trust Company of New York (Bank Leumi) under Bank Leumi's Letter of Credit # 8795 and to enjoin Bank Leumi from honoring demands for payments or performance under the letter of credit.

The debtor's application was heard on July 26, 1984.

[1] The debtor's application is denied. The court finds that there is no proper legal authority under which Republic or Bank of Leumi can be enjoined from exercising their respective rights and obligations under the letter of credit.

[2] **[3]** A letter of credit and its proceeds are not "property of the estate" within the meaning of 11 U.S.C. 541, and therefore the payment of a letter of credit is not a transfer of assets in violation of the automatic stay provisions of 11 U.S.C. 362. The letter of credit and its proceeds constitute property of the bank. *In re Page,* 18 B.R. 713, 714–16 (D.D.C.1982).

[4] Republic National Bank made an oral application at the hearing for attorneys fees under Federal Rule 11 on the ground that the debtor's application was patently frivolous. The court finds that the debtor's application was filed in good faith and therefore the application for expenses should be denied.

It is so ordered.

All Citations

41 B.R. 398

End of Document

KeyCite Yellow Flag - Negative Treatment
Called into Doubt by In re Encompass Services Corp., Bankr.S.D.Tex., January 26, 2006

430 F.3d 260
United States Court of Appeals,
Fifth Circuit.

In re STONEBRIDGE TECHNOLOGIES, INC., Debtor.
EOP–Colonnade of Dallas Limited Partnership, Appellant,
v.
Dennis Faulkner, In his capacity as Trustee of the SBTI Liquidating Trust, Appellee.

No. 04–10494.
|
Nov. 8, 2005.

Synopsis
Background: Trustee of liquidating trust established under debtor-lessee's confirmed Chapter 11 plan brought cause of action against debtor's lessor to recover for lessor's alleged breach of contract and negligent misrepresentations in drawing on letter of credit issued to secure debtor's performance under lease. The United States Bankruptcy Court for the Northern District of Texas entered judgment in favor of trustee, and lessor appealed. The District Court, Jorge A. Solis, J., affirmed.

Holdings: On further appeal, the Court of Appeals held that:

[1] trustee's claims were within "core" jurisdiction of bankruptcy court;

[2] cap on lessor's damages claim for Chapter 11 debtor-lessee's breach of rejected lease applied only to any claim lessor filed for payment of this damages claim from property of the estate, and did not limit amount that lessor could recover under letter of credit issued to secure debtor's performance under lease;

[3] motion that commercial lessor filed in debtor-lessee's Chapter 11 case to compel payment of past due rent qualified as adequate notice under lease of debtor-lessee's monetary default, of kind required to permit commercial lessor to draw on letter of credit; and

[4] bankruptcy court order providing for rejection of debtor's lease *nunc pro tunc* order cured any prematurity in lessor's draw request.

Reversed and remanded.

West Headnotes (17)

[1] **Bankruptcy**
Conclusions of law; de novo review
Bankruptcy
Clear error

On appeal from district court's decision in its bankruptcy appellate capacity, Court of Appeals applies the same standard of review as district court: Court reviews bankruptcy court's conclusions of law and mixed questions of law and fact *de novo*, and reviews bankruptcy court's findings of fact for clear error. Fed.Rules Bankr.Proc.Rule 8013, 11 U.S.C.A.

21 Cases that cite this headnote

[2] **Bankruptcy**
Court of Appeals

On appeal in bankruptcy case, Court of Appeals was obliged to raise jurisdictional issues *sua sponte*, even though neither party had raised them, where jurisdiction, at least over some of claims raised, appeared questionable.

3 Cases that cite this headnote

[3] **Bankruptcy**
Bankruptcy Jurisdiction

To determine whether particular matter falls within general jurisdiction of bankruptcy court, court asks whether outcome of proceeding could have any conceivable effect on estate being administered in bankruptcy.

7 Cases that cite this headnote

[4] **Bankruptcy**
Related proceedings

Proceeding is within “related to” jurisdiction of bankruptcy court if its outcome could alter debtor’s rights, liabilities, options or freedom of action, either positively or negatively, and it in any way impacts on handling and administration of bankruptcy estate.

7 Cases that cite this headnote

[5] **Bankruptcy**
Construction, execution, and performance

Claims asserted by trustee of liquidating trust established under debtor-lessee’s confirmed Chapter 11 plan, for lessor’s alleged breach of terms of commercial lease included in “property of the estate,” was within bankruptcy court’s general bankruptcy jurisdiction; any recovery on claims brought by trustee for breach of lease would go directly to estate for damage done to estate.

1 Cases that cite this headnote

[6] **Bankruptcy**
Construction, execution, and performance

Claims asserted by trustee of liquidating trust established under debtor-lessee’s confirmed Chapter 11 plan, in his capacity as assignee of bank that had issued letter of credit to secure debtor’s obligations under lease, for lessor’s alleged negligent misrepresentations when drawing on letter of credit were within bankruptcy court’s general bankruptcy jurisdiction; while assignment alone could not transform claims that bankruptcy court could not have heard to claims within its jurisdiction, any recovery by bank on its negligent misrepresentation claims against lessor would have impacted upon estate by alleviating need for indemnification/reimbursement from debtor.

6 Cases that cite this headnote

[7] **Bankruptcy**
Core or non-core proceedings

Proceeding is within “core” jurisdiction of bankruptcy court if it invokes a substantive right provided by title 11 or if it is proceeding that, by its nature, could arise only in context of bankruptcy case.

8 Cases that cite this headnote

[8] **Bankruptcy**
Construction, execution, and performance

Claims asserted by trustee of liquidating trust established under debtor-lessee’s confirmed Chapter 11 plan, for lessor’s alleged breach of terms of debtor’s commercial lease both by prematurely drawing on letter of credit that secured debtor’s leasehold obligations, prior to entry of bankruptcy court order approving debtor’s announced intent to reject lease, and by drawing on letter of credit for amount in excess of damages cap established by the Bankruptcy Code, came within “core” jurisdiction of bankruptcy court, where controlling questions that were raised by these breach of contract claims involved interpretation of “lease rejection” and “damages cap” provisions of the Bankruptcy Code. 11 U.S.C.A. §§ 365(a), 502(b)(6).

4 Cases that cite this headnote

[9] **Bankruptcy**

Construction, execution, and performance

Assigned claims, that trustee of liquidating trust was asserting in shoes of bank that had issued letter of credit to secure Chapter 11 debtor's obligations under its commercial lease, for lessor's negligent misrepresentations in prematurely representing that it had right to draw on letter of credit, prior to entry of bankruptcy court order approving debtor's announced intent to reject lease, and in asserting claim against letter of credit for amount in excess of damages cap established by the Bankruptcy Code, came within bankruptcy court's "core" jurisdiction, where controlling questions that were raised by these third-party, negligent misrepresentation claims involved interpretation of "lease rejection" and "damages cap" provisions of the Bankruptcy Code. 11 U.S.C.A. §§ 365(a), 502(b)(6).

5 Cases that cite this headnote

[10] **Bankruptcy**
Rejection of executory contract or lease

Cap on lessor's damages claim for Chapter 11 debtor-lessee's breach of rejected lease applied only to any claim lessor filed for payment of this damages claim from property of the estate, and did not limit amount that lessor could recover under letter of credit issued to secure debtor's performance under lease, where lessor never filed proof of claim in bankruptcy case. 11 U.S.C.A. § 502(b)(6).

2 Cases that cite this headnote

[11] **Bankruptcy**
Rejection of executory contract or lease

Cap imposed by the Bankruptcy Code on damages claims asserted by lessors of real property prevents lessor who files claim against estate from reaping an unfair share of bankruptcy estate over the remaining pool of unsecured creditors. 11 U.S.C.A. § 502(b)(6).

1 Cases that cite this headnote

[12] **Bankruptcy**
Letters of credit

Letters of credit issued to secure debtor's performance and proceeds therefrom are not included in "property of the estate." 11 U.S.C.A. § 541(a).

3 Cases that cite this headnote

[13] **Finance, Banking, and Credit**
Relation to underlying transaction; independence principle

Issuer's obligation to beneficiary of letter of credit is independent from any obligation between beneficiary and issuer's customer.

Cases that cite this headnote

[14] **Bankruptcy**
Rejection of executory contract or lease

Claim of lessor against assets of bankruptcy estate is essential precondition to applying damages cap. 11 U.S.C.A. § 502(b)(6).

Cases that cite this headnote

[15] **Bankruptcy**
Debtor's Contracts and Leases

Motion that commercial lessor filed in debtor-lessee's Chapter 11 case to compel payment of past due rent qualified as adequate notice under lease of debtor-lessee's monetary default, of kind required to permit commercial lessor to draw on letter of credit that secured debtor's performance, pursuant to "monetary default" provision of lease.

Cases that cite this headnote

[16] **Finance, Banking, and Credit**
Letters of Credit
Landlord and Tenant
Acceleration clauses

Once lease was in monetary default, as result of Chapter 11 debtor-lessee's failure to pay past due rent after being notified of its default by commercial lessor's motion to compel payment, lessor could exercise its contractual remedies, including right to accelerate, and thus did not make any negligent misrepresentation in asserting claim against letter of credit which secured debtor's performance for full amount of letter of credit; amount of letter of credit was less than accelerated rent owing under lease.

1 Cases that cite this headnote

[17] **Bankruptcy**
Effect of Acceptance or Rejection

Even assuming that lessor had prematurely drawn on letter of credit that secured Chapter 11 debtor-lessee's performance under lease, by drawing on letter prior to entry of bankruptcy court order approving debtor's announced intent to reject lease, bankruptcy court's subsequent grant of motion to reject *nunc pro tunc* to date of debtor's announced intent, to enable estate to save more than $200,000 in administrative rent expenses if lease were rejected effective only from date of entry of bankruptcy court's order, prevented estate representative from arguing that nunc pro tunc order had not also cured any prematurity in lessor's draw request.

1 Cases that cite this headnote

Attorneys and Law Firms

***263** Robert B. Millner (argued), Sonnenschein, Nath & Rosenthal, Chicago, IL, Gary S. Kessler, Howard C. Rubin, Kessler & Collins, Dallas, TX, for Appellant.

Jaime Lynn Myers, David W. Elmquist (argued), Winstead, Sechrest & Minick, Dallas, TX, for Appellee.

Appeal from the United States District Court for the Northern District of Texas.

Before KING, Chief Judge, and JOLLY and DENNIS, Circuit Judges.

Opinion

PER CURIAM:

The trustee (the "Trustee") of the liquidating trust established under the confirmed Chapter 11 plan of Stonebridge Technologies, Inc. ("Stonebridge") brought an adversary action, as lessee (the "Lessee"), against EOP–Colonnade of Dallas Limited Partnership ("EOP" or the "Lessor"), the lessor, in connection with EOP's draw on a letter of credit that was provided as security for Stonebridge's commercial lease obligations with EOP. The Trustee asserted, in the bankruptcy court, that EOP breached the lease and made negligent misrepresentations to the issuing bank by prematurely drawing on the letter of credit and retaining an amount in excess of the claim cap of 11 U.S.C. § 502(b)(6). The bankruptcy court found that EOP did breach the lease and made negligent misrepresentations by prematurely drawing ***264** on the letter of credit and retaining an amount in excess of the § 502(b)(6) cap. The district court affirmed the bankruptcy court's order, and EOP now appeals. We REVERSE. Because EOP did not file a claim in the bankruptcy case, we hold that the § 502(b)(6) cap was not triggered. Further, we hold that EOP did not prematurely draw on the letter of credit. EOP, therefore, did not breach the lease or make negligent misrepresentations to the issuing bank.

I

On September 21, 2000, EOP and Stonebridge entered into a lease ("Lease"), in which Stonebridge agreed to lease space in an EOP-owned office building. Under the terms of the Lease, Stonebridge was required to provide a security deposit to EOP, defined as "$105,298.85 in cash and a letter of credit in the amount of $1,430,065.74."

Stonebridge provided EOP with a cash payment of $105,298.85 and an irrevocable stand-by letter of credit for $1,430,065.74 ("Letter of Credit") issued by the Bank of Oklahoma ("Bank") in favor of EOP. Stonebridge executed a note payable to the Bank, secured by a certificate of deposit for $1,250,000, to reimburse the Bank in the event of a draw on the Letter of Credit.

On September 6, 2001, Stonebridge filed a Voluntary Petition under Chapter 11 of the United States Bankruptcy Code. At the time of the filing, Stonebridge owed EOP $71,895.61 for miscellaneous charges and expenses plus rent for September 2001. After filing the bankruptcy petition, Stonebridge paid EOP $50,000 to be applied against September 2001 post-petition rent. Stonebridge also initiated negotiations with EOP to reduce its lease obligations, seeking an agreement to reject the Lease as soon as possible and enter into a new short-term lease.

On October 23, EOP and Stonebridge announced an agreement in open court that the Lease would be rejected effective no earlier than October 1, 2001 and no later than October 23, 2001. It became clear at this time that the parties intended the effective rejection date to occur within that window of time, regardless of when the bankruptcy court issued its final order approving the rejection.

Prior to the October 23 court appearance, EOP initiated a draw request on October 22 to the Bank under the Letter of Credit for the full amount of the Letter of Credit. The Bank received the draw request on October 23, but refused to honor it because the request was technically deficient. Three days later, after correcting the deficiencies, EOP delivered another draw request to the Bank. The Bank received and promptly processed the second draw request, which became effective as of October 25. The Bank honored the Letter of Credit on October 30 by issuing a check for $1,430,965.74 and delivering it to EOP.

On November 8, the bankruptcy court entered a *nunc pro tunc* order approving the rejection of the Lease, rendering the rejection effective as of October 1, 2001. As part of the agreement to reject the Lease, EOP was allowed an administrative post-petition rent claim in the amount of $42,137.50, and the parties agreed that pre-petition rent due from September 1 to September 5 was $17,549.81. The record conclusively demonstrates, however, that EOP never filed a proof of claim for its actual lease rejection damages following the bankruptcy court order rejecting the lease and approving EOP's administrative rent claim.

On December 12, the Bank sought relief from the automatic stay to apply Stonebridge's ***265** certificate of deposit as reimbursement for EOP's draw on the Letter of Credit. The Trustee reached a compromise with the Bank, allowing the certificate of deposit to be applied in exchange for an assignment of the Bank's claims against EOP for the allegedly improper draw upon the Letter of Credit. The Trustee then brought this adversary action in the bankruptcy court alleging that EOP breached the Lease and, as assignee, alleging that EOP made negligent misrepresentations to the Bank, by prematurely drawing on the letter of credit and retaining an amount in excess of the § 502(b)(6) cap.

The bankruptcy court held that EOP prematurely drew on the Letter of Credit and retained an amount in excess of the § 502(b)(6) cap, resulting in a breach of the Lease and negligent misrepresentations to the Bank that the funds were "due and owing." *In re Stonebridge Technologies,* 291 B.R. 63 (Bankr.N.D.Tex. Apr.4, 2003). In ruling in favor of the Trustee, the bankruptcy court reasoned that because the Letter of Credit was part of the security deposit, it was subject to the § 502(b)(6) cap. The bankruptcy court also found that EOP's draw of the full amount of the Letter of Credit before the entry of the *nunc pro tunc* Lease rejection order was a breach of the Lease and constituted a negligent misrepresentation to the Bank that the full sum of the Letter of Credit was "due and owing." The bankruptcy court awarded to the estate: (i) damages in the amount of $180,065.74 for EOP's negligent misrepresentation to the Bank, calculated by the difference between the amount EOP drew on the Letter of Credit and the amount the Bank received from the certificate of deposit securing its obligations against the Stonebridge estate; and (ii) damages in the amount of $2,267.23 for EOP's breach of the Lease, calculated by the difference between what EOP would have been entitled to claim under 11 U.S.C. § 502(b)(6) (less a cash security deposit) and the amount the Bank collected on the certificate of deposit. EOP appealed to the district court, and the district court affirmed the bankruptcy court's ruling on January 30, 2004. EOP now appeals.

II

A

[1] We apply the same standard of review as the district court: the bankruptcy court's conclusions of law and mixed questions of law and fact are reviewed *de novo*. *AT&T Universal Card Servs. v. Mercer (In re Mercer),* 246 F.3d 391, 402 (5th Cir.2001) (en banc). Findings of fact are reviewed for clear error. *Id.*

B

[2] We must begin our consideration of this case by examining the jurisdiction of the bankruptcy court (and by extension the jurisdiction of the district court and this court). Neither party has raised jurisdictional issues,[1] but we are obligated to raise the matter *sua sponte,* certainly when jurisdiction appears questionable. *See In re Bass,* 171 F.3d 1016, 1021 (5th Cir.1999).

This appeal considers four claims brought by the Trustee against EOP in an adversary proceeding arising from Stonebridge's bankruptcy. Two claims directly relate to damage allegedly done directly to the estate by EOP's actions: (1) breach of the Lease by prematurely drawing on the ***266** Letter of Credit and (2) breach of the Lease by retaining an amount in excess of the § 502(b)(6) cap. The other two claims were assigned to the Trustee by the Bank: (3) negligent misrepresentation to the Bank that sums were "due and owing" by prematurely drawing on the Letter of Credit and (4) negligent misrepresentation to the Bank that sums were "due and owing" by drawing proceeds in excess of the § 502(b)(6) cap.

District courts have jurisdiction over bankruptcy cases, and they may refer cases at their discretion to bankruptcy courts. 28 U.S.C. § 1334 (district court jurisdiction); 28 U.S.C. § 157 (bankruptcy court jurisdiction). The jurisdictional grant to the bankruptcy court is divided into "core" and "non-core" proceedings. Core proceedings arise under title 11 or arise in a case under title 11. 28 U.S.C. § 157(b). Non-core proceedings are those proceedings that are otherwise related to a case under title 11. 28 U.S.C. § 157(c)(1). Bankruptcy judges may enter all appropriate orders and judgments in core proceedings, but unless the parties consent to core treatment, a bankruptcy judge must submit proposed findings of fact and conclusions of law in non-core proceedings to the district court. 28 U.S.C. § 157(b)-(c).

[3] [4] [5] To determine whether a particular matter falls within general bankruptcy jurisdiction, we ask whether the outcome of that proceeding could have any conceivable effect on the estate being administered in bankruptcy. *Wood v. Wood (In re Wood),* 825 F.2d 90, 93 (5th Cir.1987). More specifically, an action is related to bankruptcy if "the outcome could alter the debtor's rights, liabilities, options, or freedom of action (either positively or negatively) and which in any way impacts upon the handling and administration of the bankrupt estate." *In re Majestic Energy Corp.,* 835 F.2d 87, 90 (5th Cir.1988) (quoting *Pacor Inc. v. Higgins,* 743 F.2d 984, 994 (3d Cir.1984)). This inquiry is straightforward with respect to the breach of the Lease claims: The Lease is property of the bankruptcy estate in this case and, therefore, any breach of the Lease has an effect on the estate. Any recovery on the claims brought by the bankrupt for breach of the Lease goes directly to the estate for damage done to the estate.

[6] With respect to the claims for negligent misrepresentations that EOP made to the Bank, jurisdiction is less obvious. Although the claims are now owned by the estate by virtue of the assignment to the Trustee, they arise from litigation rights of a third party, the Bank. At first glance, one might conclude that because the estate stands in the shoes of the Bank, and the bankruptcy court had no jurisdiction to litigate the Bank's claim against EOP, the bankruptcy court could not assert jurisdiction over the claim just because the Bank's cause of action had been assigned to the estate.[2] Finding that assignment alone creates bankruptcy jurisdiction to litigate a third party's cause of action defeats the limited scope of bankruptcy jurisdiction. Upon closer review, however, additional effects on the estate are evident: a claim by the Bank against EOP affects the need for the Bank to seek reimbursement from Stonebridge's bankruptcy estate. EOP's draw on the Letter of Credit triggered Stonebridge's contractual responsibility to reimburse the Bank for the draw on the Letter of Credit. Here, however, the Bank also sought damages against EOP ***267** for negligent misrepresentation. If the Bank is successful against EOP on its negligent misrepresentation claims, the need for reimbursement from Stonebridge's estate is alleviated.[3] This effect on the estate is not altered because the Trustee exchanged reimbursement to the Bank for an assignment of the Bank's negligent misrepresentation claims. The negligent misrepresentation claims therefore fall within the general bankruptcy jurisdiction.

[7] [8] Having decided that all four claims are within the

general bankruptcy jurisdiction, we then must decide whether the claims are core or non-core. A proceeding is core "if it invokes a substantive right provided by title 11 or if it is a proceeding that, by its nature, could arise only in the context of a bankruptcy case." *Wood,* 825 F.2d at 97. Again, this inquiry is relatively easy with respect to the breach of the Lease claims. Although the breach of the Lease claims are grounded in state contract law, the controlling questions for this case involve the interpretation of substantive rights provided by title 11, the § 502(b)(6) cap and lease rejection under § 365(a).

[9] On the other hand, claims between third parties, such as the negligent misrepresentation claims, are typically considered within the bankruptcy court's non-core jurisdiction. In this case, however, the negligent misrepresentation claims are dependent upon the interpretation of rights created in bankruptcy, specifically those rights associated with § 502(b)(6) and § 365(a). Although the grafting of bankruptcy terms onto the interpretation of a Lease does not automatically result in core jurisdiction, as a practical matter, these particular negligent misrepresentation claims are substantively related to the interpretation of rights created in bankruptcy. In other words, the substantive rights asserted by the Trustee could arise only in the context of a bankruptcy case. Because these claims are dependent upon the rights created in bankruptcy and would not exist but for the filing of Stonebridge's bankruptcy, we find that these claims should be included within the bankruptcy court's core jurisdiction. *See generally Northern Pipeline Const. Co. v. Marathon Pipe Line Co.,* 458 U.S. 50, 102 S.Ct. 2858, 73 L.Ed.2d 598 (1982) (defining the limits of Article III jurisdiction of bankruptcy courts, later codified into core and non-core jurisdiction by Bankruptcy Amendments and Federal Judgeships Act of 1984, P.L. No. 98–353).

In sum, the bankruptcy court had core jurisdiction over all of the claims currently on appeal from the adversary proceeding under 28 U.S.C. § 1334 and § 157(b). The district court had jurisdiction to review the bankruptcy court's order under 28 U.S.C. § 158(a). We then have jurisdiction to review this appeal under § 158(d), so we proceed to address the merits.

C

For ease of substantive analysis, we consider the causes of action alleged by the Trustee against EOP together (breach of the Lease and negligent misrepresentation[4]), but divide the claims into two ***268** groups: (1) the claims for draw/retention in excess of the § 502(b)(6) cap and (2) the claims for premature draw.

1

[10] We first examine the claims against EOP for drawing against the Letter of Credit an amount in excess of the § 502(b)(6) cap.[5]

[11] Section 502 of the Bankruptcy Code, entitled "Allowance of claims or interests", provides that claims or interests are deemed allowed unless a party in interest objects. 11 U.S.C. § 502(a). If an objection is made, the court determines the amount of such a claim and allows the claim in the determined amount, except to the extent that certain specified conditions exist. 11 U.S.C. § 502(b). Section 502(b)(6) provides:

> (b) Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that—
>
> (6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds—
>
> (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of—
>
> (i) the date of the filing of the petition; and
>
> (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus
>
> (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates.

This limitation prevents a lessor who files a claim against the estate from reaping an ***269** unfair share of the bankruptcy estate over the remaining pool of unsecured creditors. S.Rep. No. 95–989, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5849; H.R.Rep. No. 95–595, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6309 (the purpose of the statute is "to compensate the landlord for his loss while not permitting a claim so large (based on a long-term lease) as to prevent other general unsecured creditors from recovering a dividend of the estate.").

[12] [13] In this case, the Lessor's need to file a claim against the bankruptcy estate was obviated by the fact that the Lessee's obligations were substantially secured by cash and a letter of credit, to which the Lessor turned when the Lessee defaulted.[6] The Lessor's draw on the letter of credit is the focus of the Trustee's arguments. It is well-established in this circuit that letters of credit and the proceeds therefrom are not property of the debtor's bankruptcy estate. *Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.),* 831 F.2d 586, 589 (5th Cir.1987). Insofar as letters of credit embody obligations between the issuer and beneficiary, such contractual rights and duties are entirely separate from the debtor's estate:

> [A]n issuer's obligation to the letter of credit's beneficiary is *independent* from any obligation between the beneficiary and the issuer's customer. All a beneficiary has to do to receive payment under a letter of credit is to show that it has performed all the duties required by the letter of credit.
>
> *Id.* at 590 (emphasis added). The structure of this relationship between the beneficiary (EOP), issuer (Bank), and issuer's customer (Stonebridge) is referred to as the "independence principle."

[14] By its terms, § 502(b) applies only to claims against the bankruptcy estate.[7] *See, e.g., In re SKA! Design, Inc.,* 308 B.R. 777, 781 (Bankr.N.D.Tex.2004) ("Section 502 deals only with allowance by a landlord of a claim, *if presented*, against the bankruptcy estate.") (quoting *In re Mr. Gatti's, Inc.,* 162 B.R. 1004 (Bankr.W.D.Tex.1994) (emphasis added)). Claims under § 502(b) are not automatically assumed simply because the debtor assumes or rejects a lease under § 365, but rather must be formally filed against the estate in the bankruptcy court. *See In re National Gypsum Co.,* 208 F.3d 498, 505 (5th Cir.2000) (finding that the "opportunity" to file a proof of claim arises only "*subsequent to the debtor's decision on how to treat the contract or lease*"); ***270** *In re Austin Dev. Co.,* 19 F.3d 1077, 1084 (5th Cir.1994) (finding that assumption or rejection of a lease simply entitles lessor to then file a proof of claim). Stated simply, the claim of a lessor against the assets of the estate is an essential precondition to applying the damages cap at all. *See In re Arden,* 176 F.3d 1226, 1229 (9th Cir.1999) ("[Section 502(b)(6)] has two predicates: 'claim of a lessor' and 'damages resulting from the termination of a lease or real property.' "). Thus, the damages cap of § 502(b)(6) does not apply to limit the beneficiary's entitlement to the proceeds of the letter of credit unless and until the lessor makes a claim against the estate.[8] We find, therefore, that further inquiry into the appropriate interpretation of § 502(b)(6) is unnecessary in this case because EOP did not file a claim against the estate.

Nonetheless, Stonebridge argues that the bankruptcy court reached the correct conclusion by limiting EOP to the capped amount.[9] Stonebridge asserts that the Letter of Credit is part of the Security Deposit under the Lease, thus bringing it within the purview of the § 502(b)(6) damages cap. In essence, Stonebridge argues that landlords may not offset actual damages against their security deposit and then claim for the balance under § 502(b)(6). Security deposits "will be applied in satisfaction of the claim that is allowed under [§ 502(b)(6)]." H.R.Rep. No. 95–595, at 353–55. To the extent that a landlord has a security deposit in excess of the amount of his claim under § 502(b)(6), Stonebridge asserts that the excess returns to the bankruptcy estate.

One problematic aspect of this argument is that it converts § 502(b)(6) into a self-effectuating avoiding power that would allow the trustee to bring an adversary proceeding against a lessor who exercises his rights under a letter of credit. This departs from the plain language of § 502(b)(6), which "allows only one thing—disallowance of the filed claim to the extent that it exceeds the statutory cap." Laura B. Bartell, *The Lease Cap and Letters of Credit: A Reply to Professor Dolan,* 120 Banking L.J. 828, 835–36 (2003) ("Unlike preference law, there is no provision of the Bankruptcy Code that allows the trustee to sue a lessor for receiving property, even property of the estate, merely because it exceeds the lease cap of Section 502(b)(6)."). When the Bankruptcy Code intends to create an avoidance power, it does so expressly in the language of the provision. *See, e.g.,* 11 U.S.C. § 547(b); *see also Union Bank v. Wolas,* 502 U.S. 151, 112 S.Ct. 527, 116 L.Ed.2d 514 (1991) (interpreting the scope of a trustee's avoidance powers provided under § 547). Stonebridge's argument draws an implicit analogy between the power of trustees to avoid certain preferential transfers for the benefit of the estate and the statutory cap imposed on a lessor's lease-rejection damages claim under § 502(b)(6) that simply cannot be squared with language in the Bankruptcy Code.

Moreover, Stonebridge relies on two cases from other circuits that have treated ***271** the proceeds of a letter of credit as a security deposit and capped by § 502(b)(6): *Solow v. PPI Enterprises, Inc. (In re PPI Enterprises, Inc.),* 324 F.3d 197 (3d Cir.2003), and

Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.), 306 B.R. 295 (9th Cir. BAP 2004). In both cases, however, the landlord filed a claim against the bankruptcy estate seeking lease-rejection damages in excess of the amount of the security deposit. Thus, the Trustee's reliance on these two cases is misplaced, because the record conclusively demonstrates that EOP never filed a proof of claim against the Stonebridge estate.

In sum, § 502(b)(6) does not alter the entitlement of EOP to the full proceeds of the Letter of Credit in the case where EOP has not also filed a claim against the estate for recovery of unpaid lease monies. The bankruptcy court's conclusion to the contrary was in error.

2

We next examine the claims against EOP for prematurely drawing against the Letter of Credit. The district court affirmed the bankruptcy court's holding that EOP breached the Lease and made negligent misrepresentations to the Bank by drawing down on the Letter of Credit prior to an event of default. The Lease provides:

> Landlord may, from time to time, without prejudice to any other remedy, use all or a portion of the Security Deposit to satisfy past due rent or to cure any uncured default by Tenant.

The Lease further defines the following as events of default:

> A. Tenant's failure to pay when due all or any portion of the Rent, if the failure continues for 5 days after written notice to Tenant ("Monetary Default").
>
> B. Tenant's failure (other than Monetary Default) to comply with any term, provision or covenant of this Lease, if the failure is not cured within 20 days after written notice to Tenant ....
>
> C. Tenant or any Guarantor becomes insolvent, makes a transfer in fraud of creditors or makes an assignment for the benefit of creditors, or admits in writing its inability to pay its debts when due ....

(a)

EOP asserts three separate reasons that it was entitled to the full proceeds of the Letter of Credit at the time of the draw. First, EOP argues that it did not prematurely draw down on the Letter of Credit because Stonebridge was in Monetary Default when EOP initiated the draw on the Letter of Credit. EOP contends that its motion to compel payment of unpaid post-petition rent filed seven days prior to EOP's initiation of the draw on the Letter of Credit (and served on Stonebridge's attorneys) provided written notice of Stonebridge's past due rent. Furthermore, Stonebridge acknowledged that it was in Monetary Default when it agreed that EOP was owed pre– and post-petition rent as of the rejection date. EOP contends that it was entitled to the proceeds of the Letter of Credit to cure Stonebridge's Monetary Default.

EOP also argues that it was entitled to the proceeds of the Letter of Credit because Stonebridge triggered the Insolvency Clause. Although 11 U.S.C. § 365(e)(1) prohibits the enforcement of such *ipso facto* clauses against the debtor, EOP argues that its ability to enforce its rights in the Lease against a third party letter of credit issuer is not affected by the Bankruptcy Code. Accordingly, at the time that the draw was initiated, EOP exercised its rights against the Bank under a current ***272** default and therefore did not prematurely draw on the Letter of Credit.

Finally, EOP maintains that it was entitled to the proceeds of the Letter of Credit as lease-rejection damages. EOP asserts that the bankruptcy court's November 8 entry of its *nunc pro tunc* order approving rejection of the Lease effective as of October 1 makes EOP's draw on the Letter of Credit valid. Because the retroactive order set the effective date of rejection at October 1, the draw in late October, if in error, would have been cured.

On the other hand, Stonebridge asserts that EOP drew on the Letter of Credit prior to any event of default entitling EOP to the full amount of the Letter of Credit. Stonebridge argues: (1) that there were no Monetary Defaults under the Lease that entitled EOP to the full amount of the Letter of Credit; (2) that EOP was not entitled to draw on the Letter of Credit based on Stonebridge's insolvency under 11 U.S.C. § 365(e)(1); (3) that the bankruptcy court's November 8 order did not retroactively authorize EOP's draw on the Letter of Credit; and (4) that the language of the Lease did not give EOP the right to satisfy EOP's rejection damages with the proceeds of the Letter of Credit.

(b)

[15] We have determined earlier that § 502(b)(6) was not triggered in this case and did not, therefore, cap damages payable under the Letter of Credit from the Bank to EOP. We now turn to the question of whether other factors limited damages that EOP could claim under the Letter of Credit. With the exception of the question of the timing of the lease rejection under § 365(a) (which is a question of interpreting the Bankruptcy Code and the orders issued therewith), the resolution of this question is a matter of interpreting the Lease. EOP's draw on the Letter of Credit must be supported by some provision of the Lease that rightfully entitles EOP to represent to the Bank that such funds were "due and owing."

We conclude that EOP was entitled to draw on the Letter of Credit under the "Monetary Default" provision of the Lease. At the time of the draw, we have no doubt that Stonebridge was in Monetary Default under the terms of the Lease.[10] To the extent that the bankruptcy court held otherwise by stating that "Landlord EOP never provided notice of monetary or nonmonetary default to Stonebridge," *In re Stonebridge Technologies,* 291 B.R. at 72, the bankruptcy court's conclusions are incorrect. The Lease clearly provides that Stonebridge would be in Monetary Default if it failed to pay its rent when due or any portion of the rent and failed to cure within five days of written notice. EOP's motion for payment of rent was made on October 15, 2001, seven days before EOP actually drew on the Letter of Credit and provided sufficient written notice to Stonebridge that the Lease was in Monetary Default. *See LA–Nevada Transit Co. v. Marathon Oil Co.,* 985 F.2d 797, 800 (5th Cir.1993) (holding that a notice is effective if "sufficiently clear to apprise the other party of the action being taken"). Thus, ***273** the bankruptcy court clearly erred in finding that EOP never provided adequate notice of Monetary Default to trigger its right to draw upon the Letter of Credit.

[16] Once the Lease was in Monetary Default, EOP became entitled to seek remedies, including drawing down all or a portion of the Security deposit, to cure that default under the terms of the Lease. The Lease also contains an acceleration clause under which

> Landlord may elect to receive as damages the sum of (a) all Rent accrued through the date of the termination of this Lease or Tenant's right to possession, and (b) an amount equal to the total Rent that Tenant would have been required to pay for the remainder of the Term discounted to present value at the Prime Rate ... then in effect, minus the present fair rental value of the Premises for the remainder of the Term, similarly discounted, after deducting all anticipated Costs of Reletting.

This clause provides a measurement of lease rejection damages that the Lessor can utilize in the event of a default. In fact, the measure used to calculate accelerated damages under the Lease is the same measure that would be used to calculate the damage to a lessor from the rejection of a lease when not applying the § 502(b)(6) cap. *See* 11 U.S.C. § 502(g) ("A claim arising from the rejection ... of an executory contract or unexpired lease of the debtor that has not been assumed shall be determined ... as if such claim had arisen before the date of the filing of the petition."); *City Bank Farmers Trust Co. v. Irving Trust Co.,* 299 U.S. 433, 443, 57 S.Ct. 292, 81 L.Ed. 324 (1937) ("The amount of the landlord's claim for the loss of his lease necessarily is the difference between the rental value of the remainder of the term and the rent reserved, both discounted to present worth."); Kimberly S. Winick, *Tenant Letters of Credit; Bankruptcy Issues for Landlords and Their Lenders,* 9 AM. BANKR.INST. L.REV. 733, 761 (2001) (noting that the terms of the lease agreement should be used to calculate damages when the statutory cap of § 502(b)(6) is not involved). Applying this formula in the instant case, EOP's accelerated damages under the Lease (estimated at between $1.5 and $1.6 million) exceeded the value of the Letter of Credit ($1,430,065.74).

We find, therefore, that the proceeds of the Letter of Credit were correctly applied to cover these accelerated damages. The Lease provides that EOP could use "all or a portion of the Security Deposit to satisfy past due Rent or to cure any uncured default by Tenant." The Letter of Credit, defined under the Lease as a portion of the Security Deposit, may therefore be used to satisfy past due rent or cure any uncured default. Because, in this case, those accelerated damages exceed the value of the proceeds of the Letter of Credit, EOP is entitled to the full proceeds of the Letter of Credit to cure the uncured Monetary Default.

[17] Finally, we reject the Trustee's argument that the draw

was premature based on the fact that the bankruptcy court did not issue its final order granting the administrative rent claims and setting the effective lease rejection date until November 8. First, we note that most courts have held that lease rejection may be retroactively applied. *See In re Jamesway Corp.,* 179 B.R. 33, 37 (1995) ("The majority of courts ... have held that the effective date of rejection is the date of the bankruptcy court's order approving rejection, and that court approval is a condition precedent to effective rejection."). Moreover, the parties' announcement in open court on October 23 clearly evinced Stonebridge's preference for an earlier effective rejection date, which ended up saving the estate over $200,000 in administrative rent ***274** expenses. 8 R. at 1480. We are unwilling to allow Stonebridge to reap the benefits of the retroactive order without also recognizing that the earlier date effectively cured the prematurity of EOP's draw request on the Letter of Credit. *See Browning v. Navarro,* 743 F.2d 1069, 1081 (5th Cir.1984) (applying basic rules of contract interpretation to preserve the intended compromise reached by the parties under the terms of an agreement approved by the bankruptcy court).

Accordingly, EOP did not breach the Lease or negligently misrepresent to the Bank that sums were "due and owing" by drawing the full amount of the Letter of Credit.

III

Thus, we hold that the bankruptcy court has general and core jurisdiction over the claims for breach of the Lease and negligent misrepresentation brought by the Trustee. Finding jurisdiction, we hold that § 502(b)(6) does not apply to cap the proceeds that EOP may claim against the Letter of Credit because EOP never filed a claim for damages against the Stonebridge estate. Further, we hold that the acceleration clause of the Lease permitted the draw on the proceeds of the Letter of Credit by EOP when Stonebridge defaulted on its rent payments. Consequently, there was no breach of the Lease or misrepresentation to the Bank.

For the foregoing reasons, the judgment of the district court affirming the judgment of the bankruptcy court in this adversary proceeding is REVERSED, and the case is REMANDED to the district court for further proceedings consistent with this opinion.

REVERSED and REMANDED.

All Citations

430 F.3d 260, 45 Bankr.Ct.Dec. 166, Bankr. L. Rep. P 80,389

Footnotes

1 Neither party has previously raised the question of general bankruptcy jurisdiction. EOP, however, has raised the question of core versus non-core bankruptcy jurisdiction before both the bankruptcy and district courts.

2 At oral argument before this court, counsel for the Trustee admitted that the assigned claims would not be within the bankruptcy court's jurisdiction if those claims had been brought by the Bank. We do not judge the accuracy of this statement, but note that it is such an intuition that led this Court to raise the question of jurisdiction *sua sponte.*

3 Similarly, other cases that involve litigation between third parties have been found to have an effect on the administration of the bankruptcy estate, including suits by creditors against guarantors and a suit by creditors of a debtor against defendants that allegedly perpetrated a fraud. *See* 3 COLLIER ON BANKRUPTCY ¶ 3.01 (15th ed. rev.2005) (citations omitted).

4 To present a claim of negligent misrepresentation, Stonebridge must prove: (1) EOP made a representation in the course of business, or in a transaction in which EOP had a pecuniary interest; (2) EOP supplied false information for the guidance of the Bank in its business transactions; (3) EOP failed to exercise reasonable care or competence in obtaining or communicating this information; (4) the Bank justifiably relied on the representation; and (5) EOP's misrepresentation proximately caused the Bank pecuniary injury. *See McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests,* 991 S.W.2d 787, 791 (Tex.1999). The only disputed issue before us is whether EOP falsely represented to the Bank that the full amount of the Letter of Credit was "due and owing." The inquiries undertaken to determine whether EOP falsely represented to the Bank and whether EOP breached the Lease are identical.
The parties do not raise the issue whether a tort action in the form of a negligent misrepresentation claim is available to the Bank, and thus to the Trustee as assignee of the Bank's claims, under these circumstances. *See generally In re Zamora,* 274 B.R. 268, 274 (Bankr.W.D.Tex.2002) ("With the Code's silence, the presumption is that the normal rules regarding the enforceability of valid assignments apply."). Thus, this opinion does not decide whether such a claim is indeed available to issuers of letters of credit when a misrepresentation is made in connection with a draw upon a letter

of credit and nothing in this opinion should be read to indicate that such a cause of action exists. Because of the parties' failure to address the issue, however, we analyze the Trustee's negligent misrepresentation claim under the elements of the traditional tort action.

5 Although mechanical differences may exist between drawing and retaining funds from a letter of credit, the application of § 502(b)(6) does not turn on these distinctions in this case. *See Eakin v. Cont'l Ill. Nat'l Bank & Trust Co. of Chicago,* 875 F.2d 114, 116 (7th Cir.1989) ("Letters of credit are designed to avoid complex disputes about how much the beneficiaries 'really' owe. The promise and premise are 'pay now, argue later.' ").

6 The filing of a proof of claim serves no purpose if the creditor is secured or has not asserted a claim against the estate. *See* 4 COLLIER ON BANKRUPTCY ¶ 501.01[3][a] (15th ed. rev.2005).

7 EOP first raised this argument in its reply brief in support of its motion for summary judgment in the bankruptcy court. *See* 4 R. at 678 ("In this case, EOP did not make a claim against the Debtor's estate. The 502(b)(6) cap only applies for claims against the estate. Thus, EOP did not have to take the cap into consideration in calculating its damages."). In the district court proceedings, EOP specifically devoted an entire subsection of its brief to this argument. *See* 1 R. at 47–48 ("When a creditor has a claim against a third party arising out of the actions of the debtor, or the creditor's relationship with a debtor, the creditor is not obligated to file a claim against the debtor's estate to pursue its remedy against a third party non-debtor."). This argument was reiterated in the appellant's briefs to this court, which described this proposition as "axiomatic" to the application of § 502(b)(6). Brief of Appellant at 33; *see also* Reply Brief of Appellant at 4–5. Because the record clearly demonstrates that EOP adequately briefed and preserved this argument throughout the lower court proceedings, we find no compelling reason to deem it waived on this appeal. *See Dial One of the Mid–South, Inc. v. BellSouth Telecomms., Inc.,* 401 F.3d 603, 607 (5th Cir.2005).

8 We also note that § 502(b)(6) does not apply to limit administrative expense claims made by the landlord based upon the continued use of the premises after the filing of the bankruptcy petition. *See* 4 COLLIER ON BANKRUPTCY ¶ 501.01[7][g] (15th ed. rev.2005). Thus, this court will not imply a claim for lease-rejection damages in EOP's motion for administrative rent payments.

9 It is undisputed that EOP would have been limited to rejection damages from Stonebridge's estate of $1,353,032.02 under § 502(b)(6) if it had filed a claim against the estate.

10 During the bankruptcy court proceedings, Matthew Koritz, the litigation and government affairs counsel for EOP's general partner, testified that the determination of whether funds were "due and owing" under the Lease at the time of the draw was based upon Stonebridge's failure to pay portions of pre– and post-petition rent and intention to reject the Lease in full as part of its liquidation plan. 8 R. at 1511–12. Based on the formula provided in the acceleration clause of the Lease, EOP calculated its actual rejection damages under the Lease at approximately $1.5 to $1.6 million. 8 R. at 1478. Stonebridge does not dispute this figure.

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174 A.D.2d 461
Supreme Court, Appellate Division, First Department, New York.

185 MADISON ASSOCIATES, a Co-partnership, Plaintiff–Appellant,
v.
Tom RYAN, a/k/a Thomas B. Ryan, Defendant–Respondent.

June 18, 1991.

Synopsis

Landlord sued guarantor of tenant's obligation under lease. The Supreme Court, New York County, Tompkins, J., denied landlord's motion for summary judgment and landlord appealed. The Supreme Court, Appellate Division, held that landlord's consent to sublease did not relieve tenant from obligation under lease and did not relieve defendant from personal guarantee of tenant's full performance of lease.

Reversed and motion granted.

West Headnotes (4)

[1] **Guaranty**
Change in Obligation or Duty of Principal
Landlord and Tenant
Liability of sublessor to landlord

Landlord's consent to sublease did not relieve tenant from obligation under lease and did not relieve defendant from personal guarantee of tenant's full performance of lease.

3 Cases that cite this headnote

[2] **Landlord and Tenant**
Liability of lessee after assignment

To relieve original tenant assignor from its continuing liability for rent after assignment, it must be expressly shown that lessor not only consented to assignment, but accepted assignee in place of tenant.

5 Cases that cite this headnote

[3] **Landlord and Tenant**
Liability of lessee after assignment

Release of tenant from liability for rent after assignment must either be express or implied from facts other than lessor's mere consent to assignment and its acceptance of rent from assignee.

9 Cases that cite this headnote

[4] **Guaranty**
General rules of construction

Where lease, including guarantee of tenant's performance of lease, is complete upon its face, guarantor's claim of contradictory oral agreement is insufficient to avoid liability.

Cases that cite this headnote

****245** Before SULLIVAN, J.P., and ROSENBERGER, KUPFERMAN, ROSS and SMITH, JJ.

Opinion

***461** MEMORANDUM DECISION.

Order, Supreme Court, New York County (Harold Tompkins, J.), entered June 22, 1990, which denied plaintiff's motion for summary judgment, unanimously reversed, on the law, and plaintiff's motion is granted, with costs. The clerk is directed to enter judgment accordingly.

[1] [2] [3] [4] Contrary to the finding of the IAS court, there is no conflict between paragraph 40 of the lease which provides that, in the event of a subletting, the tenant, Ryan Consulting Group, Inc., remains responsible for the payment of all rents due under the lease and the clause in Ryan Consulting Group's assignment of the lease to Robert Henkel and Associates, Inc. whereby the assignee agreed to be solely responsible for the rent. The assignment is solely an agreement between the tenant and subtenant and the plaintiff landlord's consent to the sublease did not relieve the tenant from its obligation under the lease or defendant from his personal guarantee of the tenant's full performance of the lease. It is well settled that in order to relieve the original tenant-assignor from its continuing liability after assignment, it must be expressly shown that the lessor not only consented to the assignment, but accepted the assignee in place of the tenant and such release of the tenant must either be express or implied from facts other than the lessor's mere consent to the assignment and its acceptance of rent from the assignee (74 N.Y.Jur.2d, Landlord and Tenant, § 692). Where the lease, including defendant's guarantee, is complete upon its face, defendant's claim of a contradictory oral agreement is insufficient to create an issue of fact or defeat summary judgment.

All Citations

174 A.D.2d 461, 571 N.Y.S.2d 244

KeyCite Yellow Flag - Negative Treatment
Distinguished by 29 Holding Corp. v. Diaz, N.Y.Sup., March 31, 2004

265 A.D.2d 270
Supreme Court, Appellate Division, First Department, New York.

665–75 ELEVENTH AVENUE REALTY CORP., Plaintiff–Appellant,
v.
Janet L. SCHLANGER, etc., Defendant–Respondent.

Oct. 28, 1999.

Synopsis

Landlord whose judgments against tenant for unpaid rent were unsatisfied brought suit against tenant's guarantor. The Supreme Court, New York County, Emily Goodman, J., denied landlord's motion for summary judgment. Landlord appealed. The Supreme Court, Appellate Division, held that: (1) money judgments in favor of landlord for periods after expiration of written extensions of lease did not bar litigation of issue of whether written lease existed for those periods, and (2) guarantee lapsed upon expiration of final written lease extension, even though tenant stayed in possession.

Affirmed as modified.

West Headnotes (5)

[1] **Judgment**
Nature and Requisites of Former Adjudication as Ground of Estoppel in General

Collateral estoppel only arises if a fact is decided by a court of competent jurisdiction, which is then deemed binding in any further proceeding involving the party against whom it was decided.

Cases that cite this headnote

[2] **Judgment**
Matters Not in Issue

Money judgments rendered in favor of landlord for periods after expiration of written extensions of lease did not operate under doctrine of collateral estoppel to bar litigation of issue of whether written lease existed for those periods in landlord's action against guarantor; money judgments in question were presumably for use and occupancy, to which landlord would be entitled upon expiration of lease.

1 Cases that cite this headnote

[3] **Guaranty**
General Rules of Construction

Terms of guarantee are to be strictly construed in favor of a private guarantor.

11 Cases that cite this headnote

[4] **Guaranty**
Scope and Extent of Liability

A guarantor should not be bound beyond the express terms of his guarantee.

8 Cases that cite this headnote

[5] **Guaranty**
Guaranties of Leases

Written guarantee executed by tenant's guarantor, which created obligation on part of guarantor as to "any renewal, change or extension of" lease, lapsed upon expiration of final written extension of lease, even though tenant stayed in possession of premises.

11 Cases that cite this headnote

Attorneys and Law Firms

****271** Daniel Finkelstein, for Plaintiff–Appellant.

Howard J. Goldstein, for Defendant–Respondent.

ROSENBERGER, J.P., TOM, MAZZARELLI, SAXE and BUCKLEY, JJ.

Opinion

MEMORANDUM DECISION.

***270** Order, Supreme Court, New York County (Emily Goodman, J.), entered September 30, 1998, which insofar as appealed from denied plaintiff's motion for summary judgment, unanimously modified, on the law, and upon a search of the record, summary judgment granted in favor of defendant dismissing the complaint, and as so modified, affirmed, without costs. The Clerk is directed to enter judgment in favor of defendant-respondent dismissing the complaint.

The facts are undisputed. On or about October 13, 1987, Fatice, Inc., a closely-held family-owned company, entered into a written lease with plaintiff-landlord 665–75 Eleventh Avenue Realty Corp. The original lease was executed by defendant Martin Schlanger, in his capacity as president of Fatice. Simultaneously, he also executed a separate written guaranty, which provided in pertinent part:

> The Guarantor further agrees that this guaranty shall remain and continue in full force and effect as to any renewal, change or extension of the Lease.

The lease by its terms ended on October 31, 1992, and from November 1992 through June 1995 Fatice and plaintiff-landlord entered into 25 written extensions of the lease. The final written extension agreement was dated June 1995 (date unspecified), extending the lease to June 30, 1995.

Fatice remained as a month-to-month tenant after the last written lease extension and paid monthly rent at the rate of $8,000 for the months of July, August and September 1995. Beginning in October ****272** 1995, Fatice failed to pay rent and thereafter a non-payment proceeding was commenced against Fatice claiming rents through June 1996. Fatice appeared in this non-payment action and asserted affirmative defenses, including that the lease had expired and that no written rental extension agreement existed. The Civil Court awarded a full money judgment against Fatice, Inc., as well as a later money judgment for additional rent.

Since the judgments remained unsatisfied, plaintiff commenced an action against Martin Schlanger, seeking enforcement of the guaranty he executed. Defendant Schlanger (now deceased) interposed an answer containing various affirmative defenses, including the same defense raised ***271** by Fatice, Inc. in the summary non-payment proceeding, *i.e.*, claiming that no lease extension existed between the parties after June 1995. Both sides moved for summary judgment. The Supreme Court (Emily Goodman, J.), granted the landlord's motion to the extent of striking each of the guarantor's affirmative defenses, but denied summary judgment. The landlord appeals, claiming that it was entitled to summary judgment on its guaranty claims.

The landlord's principal argument on appeal is that the doctrine of collateral estoppel bars the guarantor's position that no extension of the lease existed between the parties, because the Civil Court had previously ruled that the corporate tenant was liable for the rent and the guarantor was in privity with the corporate tenant.

[1] [2] However, the Civil Court made no findings with respect to whether or not there was an extension of the lease after June 30, 1995. Collateral estoppel only arises if a fact is decided by a court of competent jurisdiction, which would then be deemed binding in any further proceeding involving the party against whom it was decided. The money judgments rendered by the Civil Court for the period subsequent to the final written extensions of the lease were presumably for use and occupancy, to which the landlord would be entitled upon expiration of the lease.

[3] [4] [5] The terms of the guaranty, which are to be strictly construed in favor of a private guarantor (*see, Levine v. Segal,* 256 A.D.2d 199, 200, 682 N.Y.S.2d 375), only create an obligation on the part of the guarantor as to "any renewal, change or extension of the Lease." Since a "guarantor should not be bound beyond the express terms of his guarantee" (*Wesselman v. Engel Co.,* 309 N.Y. 27, 30, 127 N.E.2d 736), and since it is undisputed that there was no written lease extension beyond June 10, 1995, the guaranty lapsed, releasing the defendant from liability

under the lease.

All Citations

265 A.D.2d 270, 697 N.Y.S.2d 270, 1999 N.Y. Slip Op. 08868

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Topic VII

Tax Issues in Commercial Leasing

By

Brad Borden, Esq.

Basic and Non-Basic Tax Tips for Leasing Lawyers

Bradley T. Borden*

I. Introduction

Leases raise several tax issues. Attorneys advising landlords and tenants should be aware of the general tax aspects that affect leases. This paper covers federal income tax issues that attorneys should be aware of as they assist clients with negotiating and entering into leases. The topics range from basic tax treatment of rent payments to more complex tax accounting for prepaid and deferred rent payments to issues that arise in specific leasing and transactional contexts.

II. Tax Basics of Leasing

A lease is an arrangement that requires payment for the use of property. As such, the owner of property (lessor) grants another party (lessee) the right to use the property in exchange for consideration. Those respective transfers of value create tax consequences to both the lessor and the lessee. The general tax treatment of lease payments does not apply in the case of section 467 lease, as discussed below.

A. General Tax Treatment of Lessor

Rent is ordinary income to the lessor, when the lessor receives the rental payments. I.R.C. §§ 61(a)(5), 451. Therefore, a lessor must pay tax on rent received at ordinary income rates.

B. General Tax Treatment of Lessee

Lessees can deduct rental payments as an ordinary and necessary cost of doing business against ordinary income. I.R.C. § 162(a)(3). Lessees cannot, however, deduct prepaid rent currently. Instead, they must capitalize prepaid rent. I.R.C. § 263; Treas. Reg. § 1.263(a)-4. That means they cannot deduct prepaid rent currently. Instead, a lessee would deduct a portion of prepaid rent over the life of the lease. Treas. Reg. § 1.162-11 (providing that the purchaser of a leasehold may deduct an aliquot share of purchase price of lease each year over life of lease).

C. Asymmetry and Tax Treatment Mismatch

Because the general tax rules require the lessor to recognize income upon receipt of rent payments and require the lessee to capitalize prepaid rent and deduct it over the life of the lease, the general tax rules create asymmetry, or a reporting mismatch. That mismatch generally benefits the government with respect to prepaid rent because the government currently receives tax on rental income reported by the lessor, but the lessee deducts the rent expense over the life of the lease. The following table illustrates the potential tax-treatment mismatch of prepaid rent.

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General Tax Treatment of Prepaid Rent					
	Year 1	Year 2	Year 3	Year 4	Year 5
Payment	$900,000	$0	$0	$0	$0
Lessor Gross Income	$900,000	$0	$0	$0	$0
Lessee Deduction	$180,000	$180,000	$180,000	$180,000	$180,000

If the lessor and lessee use different accounting methods, deferred rent can also create asymmetry and mismatch. For instance, a lessee who use the accrual method of accounting deducts rent over the life of the lease, regardless of when the rent is paid. A cash method lessee would, however, generally only recognize rental income when the rent is paid. Thus, the lessee may have current deductions under the accrual method, while the lessor defers rental income until rent is paid, in the case of deferred rent. The following table shows the potential tax-treatment mismatch that results from deferred rent.

General Tax Treatment of Deferred Rent					
	Year 1	Year 2	Year 3	Year 4	Year 5
Payment	$0	$0	$0	$0	$900,000
Lessor Gross Income	$0	$0	$0	$0	$900,000
Lessee Deduction	$180,000	$180,000	$180,000	$180,000	$180,000

The mismatch that results from the general tax treatment of rent payments can create tension between the lessee and lessor. The lessee would like to have a current deduction, but the lessor would prefer to defer income recognition. If both lessor and lessee are accrual method taxpayers, then they should both report the accrual of rents at the same time. In such situations, the tension would relate to timing of the payment. The lessee would prefer to receive payments as the rental income accrues, and the lessor would prefer to defer payment as long as possible. Congress recognizes this tension exists between lessors and lessees and created a tax regime to leverage that tension to create self-policing system that allows lessors and lessees to work together to develop rental accrual schedules. The regime also provides the IRS authority to determine accrual schedules if it finds that the accrual schedule used by the lessor and lessee is designed to avoid taxes.

III. Section 467 Leases

Congress enacted section 467 to eliminate tax-reporting mismatch caused by tax accounting rules and to harness tax-avoidance schemes that took advantage of that mismatch. Section 467 uses rental accrual rules to match when a lessee deducts rent payments with when lessor recognizes income. The application section 467 to two types of lease arrangements could be deemed by the lessor or lessee to be punitive, but outside those two types of arrangements, and within certain regulatory parameters, section 467 provides an opportunity for lessor and lessee to negotiate the timing of the rental deductions and income.

In the section 467 legislative history, Congress recognized that the mismatch of income recognition and deductions provided opportunities for lessors and lessees to time payments to defer income recognition and advance rental deductions. Congress particularly identified leases with "backloaded" or "stepped" rents. With such leases, an accrual method lessee could deduct rents as they accrued over the life of the lease, while a cash method lessor deferred income recognition until receipt of payment at the end of the lease. If the tax situation of the lessor and lessee differed significantly, they could time lease payments and accrual to minimize the overall tax effect of the lease. For instance, if the lessor had significant current and carryover operating losses, the lessor would be amenable to recognizing rental income currently. Thus, the lessor might agree to a prepaid or frontloaded rent. The lessee would still have to capitalize and amortize any prepaid or frontloaded rental payments but would be happy with earlier deductions.

In enacting section 467, Congress provided the IRS with a tool to challenge and recharacterize leases that were designed to avoid federal income tax or did not provide for adequate interest payments. It also includes a self-policing mechanism that draws upon the tension that exists between lessors and lessees. Under that self-policing mechanism, lessors and lessees self-police tax reporting. For instance, a lessor and lessee may create rental accrual schedule that does not necessarily track rental payments. The catch is that the lessor and lessee must include adequate interest on fixed rent and recognize tax aspects of rent payments at the same time, so the lessor recognizes rental income at same time lessee takes rental deduction.

The self-policing mechanism breaks down if the parties' tax situations differ. For instance, a tax-exempt lessor would not worry about front-loaded rental accrual, but a lessee with significant current taxable income would favor front-loaded rental accrual. Alternatively, a lessee may have considerable current losses and not need the current deduction and agree with a lessor that has significant current income to backloaded rental accrual. Congress recognized these possibilities and provides a mechanism for the IRS to curtail such arrangements.

The self-policing mechanism of section 467 provides generally that if section 467 applies, the lessor and lessee must treat rents in the same manner, i.e., recognize the income and take the deductions at the same time. Additionally, the lessor and lessee must use the accrual method of accounting, regardless of their overall methods of accounting.

A. Applicability of Section 467

Section 467 only applies to "section 467 rental agreements." I.R.C. § 467(a); Treas. Reg. § 1.467-1(a)(2). The definition of section 467 rental agreement has two elements:

1. The agreement is for the use of tangible property, and
2. The agreement provides for
    a. Uneven (increasing or decreasing) rents, or
    b. Prepaid or deferred rent.

I.R.C. § 467(d)(1); Treas. Reg. § 1.467-1(c)(1). Agreements that provide for aggregate rents of less than $250,000 are excluded from the definition of section 467 rental agreements. I.R.C. § 467(d)(2); Treas. Reg. § 1.467-1(a)(2).

If section 467 applies, one of the section 467 rental accrual methods determines the amount of the lessor's rental income and the lessee's rental deduction for any taxable year. The section 467 accrual methods are:

1. The constant accrual method, Treas. Reg. § 1.467-1(e)(2)(i), -3,
2. The proportional accrual method, Treas. Reg. § 1.467-1(e)(2)(ii), -2, and
3. Rental agreement accrual method, Treas. Reg. § 1.467-1(e)(2)(iii).

The methods are mutually exclusive, so only one method will apply to a section 467 lease agreement. The applicable method determines the amount of fixed rent for each period of a lease, which becomes part of the section 467 rent that the lessor and lessee must account for in a given accrual period. Treas. Reg. § 1.467-1(b), -1(d)(1). Thus, in analyzing the different accrual methods, the focus is on which method applies to a particular section 467 rental agreement and determining the result of applying a particular method to an agreement.

B. Constant Rental Accrual Method

The constant rental accrual method applies to disqualified leasebacks and long-term agreements that do not provide for permissible accruals. I.R.C. § 467(b)(2), (3); Treas. Reg. § 1.467-1(d)(2)(i). Only the IRS can determine if lease is disqualified, so only the IRS can apply the constant rental accrual method. Stough v. Comm'r, 144 T.C. 306 (2015); Treas. Reg. § 1.467-3(a). A section 467 rental agreement is a disqualified if it (1) is either a leaseback or a long-term agreement, (2) the principal purpose of increasing or decreasing rents is the avoidance federal income tax, and (3) the IRS determines the leaseback or long-term agreement should be disqualified. I.R.C. § 467(b)(4); Treas. Reg. § 1.467-3(b)(1).

1. Leaseback or Long-Term Lease

A rental agreement is a leaseback if the lessee had any interest in the property at any time during the two-year period that ends on the date of the agreement. Treas. Reg. § 1.467-3(b)(2). A rental agreement is long-term if the lease term exceeds 75% of the property's statutory recovery period. I.R.C. § 467(b)(4)(A); Treas. Reg. § 1.467-3(b)(3)(i). The statutory recovery period of most real property, including land (which does not qualify for the depreciation deduction), is 19 years. Treas. Reg. § 1.467-3(b)(3)(ii). Thus, a rental agreement of real property is long-term if it runs for more than 14.25 years (19 × 75%).

2. Tax-Avoidance Purpose

The IRS will apply a facts and circumstances test to determine whether increasing or decreasing rents in an agreement have the principal purpose of avoidance of federal income tax. Treas. Reg. § 1.467-3(c)(1). The regulations provide safe harbors that show tax avoidance is not a principal purpose for increasing or decreasing rents, but failure to come within one of the safe harbors does not, by itself, indicate the agreement had a principal tax avoidance purpose. *Id.* The IRS will closely scrutinize any arrangement if the marginal tax rates of the lessor and lessee can reasonably be expected at some time during the lease term to be significantly different. Treas. Reg. § 1.467-3(c)(2)(i). The difference in marginal rates is significant if, in the case of an agreement with increasing rents, the lessor's marginal tax rate is expected to exceed the lessee's marginal tax rate by 10 percentage points during the lease term. Treas. Reg. § 1.467-3(c)(2)(ii)(A). In the case of a lease agreement with decreasing rents, the difference in marginal tax rates is significant if the lessor's marginal tax rate is expected to be more than 10 percentage points greater than the lessee's. Treas. Reg. § 1.467-3(c)(2)(ii)(B). In such situations, the lessor or lessee under scrutiny will have to show by clear and convincing evidence that the rental agreement did not have tax avoidance as a principal purpose. Treas. Reg. § 1.467-3(c)(2)(i).

The following are examples of when the difference between the lessor's and lessee's marginal tax rates might be significant.

1. The lessor is a tax-exempt entity, the taxable lessee has significant income, and the rental agreement provides for decreasing rents. In such a situation, the lessor does not pay tax on prepaid rent, and the lessee benefits from current deductions.
2. The lessee has current and projected operating losses, the lessor has significant income, and the rental agreement provides for increasing rents. In such situation, the lessor benefits from deferral of income recognition, and the lessee is indifferent about not getting deductions currently

Increasing or decreasing rents in these situations would appear to be in a rental agreement for the principal purpose of avoiding federal income tax, and the IRS would most likely scrutinize such arrangements.

3. Non-Avoidance Safe Harbors

The following situations come with the non-avoidance safe harbors. IRC § 467(b)(5); Treas. Reg. § 1.467-3(b)(3). Under the safe harbor, tax avoidance is not a principal purpose if increasing or decreasing rents meet the uneven rent test. Treas. Reg. § 1.467-3(c)(3)(i). Rents meet the uneven rent test if the amount of rent allocated to each calendar year is within 10 percent of the average rent for all calendar years. Treas. Reg. § 1.467-3(c)(4). An agreement also comes within the safe harbor if an increase or decrease in rent is wholly attributable to one or more of the following: (1) a contingent rent provision or (2) a single rent holiday allowing reduced rent for one consecutive period of the lease for less than three months or for a commercially reasonable period that cannot be in excess of the lesser of 24 months and 10 percent of the lease term. Treas. Reg. § .1467-3(b)(3)(ii).

4. IRS Application of the Constant Rental Accrual Method

If the IRS determines that the constant rental accrual method applies, the constant rental amount equals that amount the provides a present value equal to the present value of all amounts payable under the lease. Treas. Reg. § 1.467-3(d)(1). The IRS deploys a three-step process to compute a constant rental amount:

Step 1: determine present value of amounts payable under disqualified lease;
Step 2: determine present value of $1 to be received at end of each rental period; and
Step 3: divide Step 1 amount by Step 2 amount.

Treas. Reg. § 1.467-3(d)(3). The result of the process is the fixed rent for each accrual period of the lease. Treas. Reg. § 1.467-1(d)(2)(i). Example 1 illustrates the application of the steps to determine the constant rental amount.

Example 1: Application of the Constant Rental Accrual Method. The IRS determines that a rental agreement is a disqualified sale-leaseback. The rental agreement provides for deferred rent, and the lessor's marginal tax rate exceeds the lessee's marginal tax rate by a significant amount. The lease agreement includes the following payment schedule for year-end payments:

Schedule of Rent Payments due under Agreement					
	Year 1	Year 2	Year 3	Year 4	Year 5
Rent	$0	$0	$0	$17,500,000	$17,500,000

The IRS would deploy the three-step process to determine the constant rental amount.

<u>Step 1: Determine the present value of rent payments (assumes a 12% applicable rate).</u>

$$\$21{,}051{,}536 = \frac{\$0}{(1.12)^1} + \frac{\$0}{(1.12)^2} + \frac{\$0}{(1.12)^3} + \frac{\$17{,}500{,}000}{(1.12)^4} + \frac{\$17{,}500{,}000}{(1.12)^5}$$

<u>Step 2: Determine the present value of $1 received at end of each rental period.</u>

$$\$3.6047762 = \frac{\$1}{(1.12)^1} + \frac{\$1}{(1.12)^2} + \frac{\$1}{(1.12)^3} + \frac{\$1}{(1.12)^4} + \frac{\$1}{(1.12)^5}$$

<u>Step 3: Determine the constant rental amount by dividing the Step 1 amount by the Step 2 amount.</u>

$$\$\mathbf{5,839,910} = \frac{\$21{,}051{,}536}{\$3.6047762}$$

Because $5,839,910 is the constant rental amount, the lessor must report $5,839,901 as gross income for each year of the lease, and the lessee may deduct the same amount as rent expense for each year of lease. Treas. Reg. § 1.467-3(e), Ex. 6.

The application of the constant rental accrual method also results in a section 467 loan. The discussion below illustrates how to compute the loan amount and the interest imputed under a section 467 loan. A section 467 loan is a deemed loan, and it can be from either the lessor or the lessee. In this situation, because the rent payments are deferred, the lessor will be deemed to loan the money to the lessee and will have interest income over the life of the lease.

C. Section 467 Proportional Rental Accrual Method

The proportional rental accrual method can only apply if a section 467 rental agreement is not subject to the constant rental accrual method. Treas. Reg. § 1.467-1(d)(2)(ii). Thus, the proportional rental accrual method cannot apply to a section 467 rental agreement that the IRS determines is a disqualified leaseback or long-term agreement. Treas. Reg. § 1.467-2(a)(1). The rental agreement also must fail to provide for adequate interest on fixed rent. Treas. Reg. § 1.467-2(a)(2). The proportional rental accrual method would generally apply only if the payment schedule under the rental agreement differs from the accrual schedule in the rental agreement.

After determining that a rental agreement is not a disqualified leaseback or long-term lease, the next step in applying the proportional rental accrual method is to determine whether the rental agreement provides for adequate interest on fixed rent. If not, the parties must compute the proportional rental amount.

1. Adequate Interest on Fixed Rent

A section 467 rental agreement fails to provide for adequate interest on fixed rent, if it does not satisfy one of the definitions of adequate interest on fixed rent. A rental agreement provides for adequate interest on fixed rent if it that has no deferred or prepaid rent. Treas. Reg. § 1.467-2(b)(1)(i). Other agreements can provide for adequate interest on fixed rent in one of multiple different ways, depending upon the type of rent provided for in the rental agreement.

A section 467 rental agreement with deferred or prepaid rent provides adequate interest on the fixed rent if the rental agreement provides for interest on deferred or prepaid rent at a single rate, includes a stated rate of interest that is no lower than 110% of AFR, adjusts the amount of deferred and prepaid fixed rent at least annually to reflect amounts paid and owing, and requires interest to be paid or compounded at least annually. Treas. Reg. § 1.467-2(b)(1)(ii).

A section 467 rental agreement with deferred, but not prepaid, rent provides for adequate interest on fixed rent if the sum of the present value of all amounts payable by the lessee as fixed rent and interest is greater than or equal to the sum of the present value of the fixed rent allocated to each rental period. Treas. Reg. § 1.467-2(b)(1)(iii).

A section 467 rental agreement with prepaid, but no deferred, rent provides for adequate interest on fixed rent if the sum of the present value of all amounts payable by the lessee as fixed rent, plus the sum of the negative present values of all amounts payable by the lessor as interest, if any, on prepaid fixed rent, is less than or equal to the sum of the present value of fixed rent allocated to each rental period. Treas. Reg. § 1.467-2(b)(1)(iv).

A section 467 agreements with variable interest must use fixed rate substitutes to determine if it provides for fixed rates of interest. Treas. Reg. § 1.467-2(b)(2).

A section 467 agreement with both deferred and prepaid rent provides for adequate interest if the agreement satisfies the requirements of a rental agreement with deferred or prepaid rent, has a single fixed rate of interest on deferred rent, and has a single fixed rate of interest on prepaid rent. The rates of interest on prepaid and deferred rent can differ. Treas. Reg. § 1.467-2(b)(3).

2. Computation of Proportional Rental Amount

If a section 467 rental agreements is not a disqualified leaseback or long-term lease and does not provide for adequate interest, the proportional rental amount is determined by multiplying the rent allocated to a rental period by the following fraction:

$$\frac{present\ value\ of\ amounts\ payable + interest}{present\ values\ of\ fixed\ rents\ allocated\ to\ each\ period}$$

Treas. Reg. § 1.467-2(c)(1).

3. Application of Proportional Rental Accrual Method

Example 2 illustrate the application of the proportional rental accrual method.

Example 2: Application of the Proportional Rental Accrual Method. A rental agreement that does not provide for an interest rate at a fixed rate has the following schedule of rent payments and allocations of rent.

Schedule of Rent Allocated and Payments due under Agreement			
	Year 1	Year 2	Year 3
Rent Allocation	$800,000	$1,000,000	$1,200,000
Rent Payment	$0	$0	$3,000,000

This agreement provides for deferred rent (rent paid only in Year 3), but not prepaid rent. Thus, it will have adequate interest if the sum of the present values of all amounts payable are greater than the sum of the present values of the fixed rent allocated to each rental period. Because the total rent allocated to each period equals the rent payable and some of the rent is allocated to Year 1 and Year 2, the sum of the present values of the rent allocated will exceed the present value of the rent payable. The computation of the present value proves out that conclusion. Assuming an applicable rate of 8.5%.

$$present\ value\ of\ amount\ payable = \$2{,}348{,}724 = \frac{\$3{,}000{,}000}{(1.085)^3}$$

$$present\ value\ of allocated\ rent = \$2{,}526{,}272 = \frac{\$3{,}000{,}000}{(1.085)^3}$$

Notice that $2,526,272 present value of the allocated rent is greater than the $2,348,724 of present value of rent payables. Thus, the following fraction would apply in determining the rent allocated to each period to compute the proportional rental amount for each rental period.

$$Fraction = .\mathbf{9297294} = \frac{\$2{,}348{,}724}{\$2{,}536{,}272}$$

The proportional rental amount for each rental period equals the rent allocated to each period multiplied by that fraction.

Year 1: $\$800{,}000 \times .9297294 = \$743{,}776$
Year 2: $\$1{,}000{,}000 \times .9297294 = \$929{,}729$
Year 3: $\$1{,}200{,}000 \times .9297294 = \$1{,}115{,}663$

Treas. Reg. § 1.467-2(f), Ex. 3.

As with the constant rental accrual method, the proportional rental accrual method results in a section 467 loan.

D. Section 467 Loans

The section 467 loan rules apply to rental agreements that are subject to either constant rental accrual method or proportional rental accrual method. Treas. Reg. § 1.467-4(a)(2), (3). A section 467 loan exists if, as of the first day of the rental period, the amount of fixed rent stated in the agreement differs from the amount determined under one of those methods. Treas. Reg. § 1.467-4(a)(1).

1. Principal Balance and Effect of Section 467 Loan

A section 467 loan can have either a positive principal balance or negative principal balance. Treas. Reg. § 1.467-4(a)(1). If a section 467 loan has a positive principal balance, it is a loan from lessor to lessee, so the lessor is deemed to be lending lessee accrued unpaid rent. Under such a situation, the lessor has interest income, and the lessee has interest expense. Treas. Reg. § 1.467-1(e)(3). If a section 467 loan has a negative principal balance, the loan is deemed to be from lessee to lessor, so the lessee is deemed to be lending lessor prepaid rent. Under such a situation, the lessee has interest income, and the lessor has interest expense. Treas. Reg. § 1.467-1(e)(3).

2. Computation of Section 467 Loan Principal Balance

The principal balance of a section 467 loan at the beginning of a rental period is determined using the following formula: fixed rent accrued in preceding years + (lessor's interest income for preceding years + interest payable to lessor on or before first day) – (lessee's interest income on prepaid fixed rent for prior rental periods + amount payable to lessor before first day as interest). Treas. Reg. § 1.467-4(b). Example 3 draws upon the facts in Example 2 to illustrate how to determine the amount of a section 467 loan.

Example 3: Computation of Section 467 Loan and Interest. The section 467 rental agreement in Example 2 required the application of the proportional rental accrual method to determine the fixed rent for each rental period. The following table summarizes the result of the application of that method.

Schedule of Rent Allocated and Payments due under Agreement			
	Year 1	Year 2	Year 3
Rent Allocation	$800,000	$1,000,000	$1,200,000
Rent Payment	$0	$0	$3,000,000
467 Rent	$743,776	$929,729	$1,115,663

Using this information, the parties can determine the amount of section 467 loan outstanding at the beginning of each rental period and the amount of interest that will accrue on that loan. At the beginning of Year 1, no rent had accrued because the Year 1 rent accrues at the end of the year. At the beginning of Year 2, the accrued rent will equal $743,776. Assuming an 8.5% yield, the lessor will have interest income of $63,221 in Year 2, and the lessee will have an interest expense in the same year.

At the beginning of Year 3, the $1,736,726 outstanding balance will include the $743,776 of Year 1 rent, the $63,221 of Year 2 interest, and the $929,729 of Year 2 rent. The Year 3 interest on that amount will be $147,622. The outstanding balance increases by that amount of interest and the $1,115,663 of Year 3 rent to $3,000,000, as summarized in the following table.

Amount of 467 Loan + Interest (assume 8.5% yield)			
	Year 1	Year 2	Year 3
Accrued Fixed Rent (beginning)	$0	$743,776	$1,736,726
Lessor's Interest Inc.	$0	$63,221	$147,622
Interest Payable to Lessor	$0	$0	$0
Lessee's Interest	$0	$0	$0
Amount Payable to Lessor	$0	$0	$0
Outstanding Loan Balance (end)	$0	$806,997	$1,884,348
Ending Loan Balance			$3,000,000

Because the loan has a positive principal balance, its from the lessor to the lessee. The lessor therefore has $63,221 of interest income in Year 2 and $147,622 of interest income in Year 3, and the lessee has the same of amounts of interest expense in those years. The rules thus treat the lessor as lending the amount of section 467 rent to the lessee, treats the lessee as paying the rent to the lessor, and, at the end of the rental agreement, the lessee pays the principal and outstanding balance of the loan to the lessor.

E. Section 467 Rental Agreement Accrual Method

The section 467 rental agreement accrual method only applies if lease not subject to constant rental accrual method or proportional rental accrual. Treas. Reg. § 1.467-1(d)(2)(iii).

Thus, the rental agreement must provide adequate interest on fixed rent, and the rental agreement cannot be for disqualified leaseback or long-term lease. If a section 467 lease agreement qualifies for the rental agreement accrual method, tax law will follow accrual schedule in rental agreement. IRC § 467(b)(1). A rental agreement specifically allocates fixed rent to a rental period if it unambiguously specifies a fixed amount of rent for which the lessee becomes liable for use of the property during the period, and the total amount of fixed rent specified equals the total amount fixed rent payable under the lease. Treas. Reg. § 1.467-1(c)(2)(ii)(A)(*2*). If there is no specific allocation, the amount of rental allocated to a rental period is the amount of fixed rent payable during that rental period. Treas. Reg. § 1.467-1(c)(2)(ii)(B).

This method allows parties to a section 467 rental agreement to create the rental accrual schedule. They could frontload rent payments and backload accrual or backload payments and frontload accrual. If the structure does not have tax avoidance as the principal purpose, then the IRS would not be able to apply the constant rental accrual method. If the agreement had adequate interest on fixed rent, then the constant rental accrual method would not apply. Thus, the parties must take into account their respective preferences for recognizing income and taking deductions, compare their tax rates and account for the time value of money when schedule payments and rent accruals. These factors create some parameters, but do not prohibit the parties from allocating rents in values that differ from payments of rents. This fact is manifest in Example 2, which applies the constant rental accrual method. The parties to the rental agreement in that example should have been able to use the resulting accrual schedule to allocate rents, and the agreement should have had adequate interest on fixed rent. The parties would, of course, have to account for the interest as well as the rent with such a schedule.

IV. Tax Treatment of Improvements to Leased Property

Improved leased property raises tax issues related to depreciation deductions of the property and to tax treatment of tenant improvements that revert to the lessee on termination of the lease.

A. Depreciation Deductions

Depreciation deductions are valuable because they reduce taxable income without affecting operating cash flow. As a general matter, the owner of property gets depreciation deductions. Therefore, the lessor typically gets depreciation deductions for improvements the lessor constructs on leased property. The lessee typically gets depreciation deductions for tenant improvements. In determining who gets the deprecation deductions, courts look to which party invested capital in the improvements. Hopkins Partners v. Comm'r, 97 T.C.M. (CCH) 1560 (2009).

B. Lessee Improvements

Generally, lessee improvements are excluded from lessor's income upon lease termination when the improvements revert to the lessor. I.R.C. §§ 109, 1019.

A lessee must capitalize the cost of lessee improvements. I.R.C. § 263. Regardless of who qualifies for the depreciation deductions, the paying party must capitalize the cost of improvements and depreciate the cost over applicable MACRS recovery period—not life of lease. I.R.C. § 168(i)(8)(A). Thus, if a lease has 25 years remaining, but the recovery period of property the lessee constructs is 39 years, a lessee must compute depreciation deductions related to tenant improvements over 39 years.

Tenant improvements can be a substitute for rent, in which case, the improvements give rise to lessor as ordinary rental income. The lessee can deduction cost of rent-substitute improvements currently against ordinary income, if the substitute improvements are for current rent. Hopkins Partners v. Comm'r, 97 T.C.M. (CCH) 1560 (2009); Treas. Reg. § 1.109-1.

V. Tax Classification of Leases

Leases are leases are leases . . . unless tax law classifies them as something else. Such reclassification is possible when an arrangement that is labeled a lease is substantively something different from a lease for tax purposes. Consider two possible reclassifications of leases—a reclassification to a sale or financing and a reclassification to a partnership.

A. Lease vs. Sale/Financing

A lease is a finance transaction. A lease provides the lessee the right to use property in exchange for making payments. As the discussion of section 467 illustrates, a lease with prepaid or deferred rent can create a loan with interest, at least for tax purposes. A lease also provides an asset and liability for each party to the lease. The lessor has a right to rental payments, and the lessee has a right to use the property. The lessor has an obligation to make the property available to the lessee, and the lessee has an obligation to pay rent. Sophisticated lessees and lessors will also recognize that deferred and prepaid rent have time-value-of-money implications. Thus, leases have attributes of many finance arrangements.

An arrangement that is labeled a lease may lack the attributes that make it a lease and begin to look like a sale from the lessor to the lessee or a financing arrangement with the lessor providing financing for the lessee to purchase the property. The structure of the former transaction would include the lessor leasing the property to the lessee, but the form may reflect a seller-financed transfer of the property. The structure of the latter transaction would represent the lessor acquiring property and leasing it to the lessee. In substance, such a transaction may be nothing more than the lessee providing financing for the lessee to acquire the property.

If the transaction is a seller-financed transfer, the "lessor" would realize gain at the inception of the arrangement (and most likely recognize the gain as payments are made under the installment method), and the "lessee" would take a basis in the property equal to is purchase price. Regular "lease" payments would be treated as debt service. Tax law looks at the substance of transactions to determine their proper classification.

Tax law generally recognizes that the party that holds the benefits and burdens of a property is the tax owner of the property. Courts consider the following several factors in determining who holds the benefits and burdens.

- How do the parties treat the transaction?
    - Rent payments or debt service and interest?
    - Lessor recognizes gain upon entering into the lease?
    - Which party is claiming depreciation deductions?
- Does the lessor have an equity interest in the property?
- Will the property have any economic value at the end of the lease term?

  - If the lessee consumes all of the property's economic value during the lease term, the lease looks more like a sale
- Does lessee have option to purchase at below market at end of lease term?
  - If the exercise price of the option is well below market, the rational lessee will exercise the option and acquire the property. The lessee may turn around and sell it immediately, but a low exercise price transfers benefits to the lessee.
- Does the lessor have a present obligation to transfer title to the property?
- Who bears the risk of loss?
- Who owns the upside?

Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Torres v. Commissioner, 88 T.C. 702, 720-722 (1987); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237-1238 (1981); Estate of Thomas v. Commissioner, 84 T.C. 412, 433-436 (1985).

B. Lease vs. Partnership

The IRS could also find that something that the parties call a lease is actually a partnership. State law provides that a partnership is "an association of two or more persons to carry on as co-owners a business for profit." If rent is based upon the lessee's profits, the IRS may scrutinize the arrangement more closely. To avoid the risk of that scrutiny, the parties may prefer to base rent on gross receipts. The parties should also consider who the ultimate disposition of the property, which relates to ownership and co-ownership. The question of whether a partnership exists is one of the most difficult questions in partnership tax, if a situation raises the question. *See* Bradley T. Borden, *The Federal Definition of Tax Partnership*, 43 HOUS. L. REV. 925 (2006). The question is also a matter of federal tax law, so state law classification is not determinative.

VI. Synthetic Leases

Synthetic leases have been a popular finance structure for many years, but changes in GAAP may be dampening their attractiveness. The essence of a synthetic lease is that the user is treated as the owner of the property for tax purposes. For GAAP purposes, the arrangement is an operating lease, so the parties do not have to report liabilities in their financial statements. Synthetic leases are typically used for assets such as corporate headquarters, other real estate projects, or corporate aircraft. They are only relevant for parties who provide GAAP financial statements.

A. Financing structure

The lease documents of a synthetic least typically provide for a short-term lease (less than 10 years, including renewal options). The lease uses purchase options and rights of termination to shift the benefits and burdens of ownership to the lessee. For GAAP purposes the user is deemed to enter into an operating lease with the "lender."

VII. REITs and Rents

REIT income tests require that 95% (passive type income) and 75% (income from real property) of the REIT's gross income derive from specific sources, including Rents from real property. IRC § 856(c)(2), (3). For payments to come within the definition of rents from real property they must be for the use of real property. IRC § 856(d)(2). Numerous cases and rulings and recent regulations address the definition of real property. *See* Bradley T. Borden, *Reforming REIT Taxation (or Not)*, 53 HOUS. L. REV. 1 (2015); Treas. Reg. § 1.856-10.

For REIT purposes, rent excludes payment for services provided to tenants, other than customary services. IRC § 856(d)(1). Non-customary services can be provided to tenants of REIT property by independent contractors and taxable REIT subsidiaries. IRC § 856(d)(2)(C), (7).

VIII. Tax Treatment of Lease Termination Payments

A lease termination fee paid from a lessee to a lessor is ordinary income to the lessor. Hort v. Comm'r, 313 U.S. 28 (1941); Treas. Reg. § 1.61.8(b). The lessee should be able to deduct such a termination fee currently. Cassatt v. Comm'r, 137 F.2d 745 (3d Cir. 1943).

A lessor must capitalize a termination fee paid to a lessee. Treas. Reg. § 1.263(a)-4(d)(7)(i)(A). The lessor either adds the fee to the basis of the property, recovers it over the unexpired term of the terminated lease, or recovers it over another lease the lessor enters into in a transaction related to the termination. Handlery Hotels, Inc. v. United States, 663 F.2d 892 (9th Cir. 1981). The lessee treats the receipt of such a payment as an amount received in exchange for selling the lease. I.R.C. § 1241. The lessee's tax treatment will therefore depend upon whether the lease is a capital asset or business-use property for the lessee, which would result in capital gains or losses, or another type of asset, which would result in ordinary income.

IX. Use of Leases in Land-Building Splits

With land-building splits, the owner of improved property transfers title to a building on land and retains the land. The purchaser of the building uses the lease to obtain access to the land on which the building stands. Several cases have considered whether attempts to split buildings from land have been successful.

A. Unsuccessful Splits

Courts have provided a list of Indicia of lease, but no transfer of building in attempted land-building splits:

- Lessee required to restore destroyed building
- Lessee must post bond equal to demolition and construction costs to replace existing building
- Lessee required to insure building
- Recovery from loss of building paid to lessor
- Lessee must maintain the building in good condition
- Title to building reverts to lessor when lease terminates
- Lessee is not permitted to sever or remove the buildings

Gates v. Helvering, 69 F.2d 277 (8th Cir. 1934); Lindley's Trust No. 1 v. Comm'r, 120 F.2d 998 (8th Cir. 1941); Crile v. Comm'r, 55 F.2d 804 (6th Cir. 1932); Estate of Budd Frankenfield v. Comm'r, 17 T.C. 1304 (1952); Minneapolis Syndicate v. Comm'r, 13 B.T.A. 1303 (1928).

B. Successful land-building splits

Perhaps the most common example of a land-building split is a condominium sale. The IRS has ruled that a land-building split was successful with respect to a condominium sale, in which the lessee had the right to remove the condominium at end of the ground lease, the lessor had to acquire units that were not removed at end of the lease, and the owner of the improvements would receive proceeds from condemnation. Rev. Rul. 70-607, 1970-2 C.B. 9. The tax court has held that the right to remove building is strong indication of split. Waldrep v. Comm'r, 52 T.C. 640 (1969). A federal district court has held that the right to remove building and a right to insurance proceeds are indicia of a split. Bratton v. Rountree, 37 A.F.T.R.2d 76-762 (M.D. Tenn. 1976).

One way to approach the land-building split question is to consider whether the building will have any value and remaining useful life at the end of the lease of term. If it does, and it will revert to the land owner, then the lessee would not appear to own the building. If the lessee will consume the useful life and value of the building, then it is more likely that lessee owns the building. Some buildings retain useful life for the decades, so they may have remaining useful life even after a 99-year lease expires.

X. Exchanging Leases under New Section 1031

Leases appear to qualify for like-kind exchange treatment under section 1031. Section 1031 requires relinquished and replacement property to be real property and like kind. IRC § 1031(a). Leasehold of a fee with 30 years or more to run is like kind to real estate. Treas. Reg. § 1.1031(a)-1(c)(2).

The real-property requirement in section 1031 became part of the law with the enactment of the Tax Cuts and Jobs Act of 2017 at the end of 2017. That new requirement raises the question of whether a leasehold in real property comes within the definition of real property under section 1031. Tax law recognizes that leases are intangible personal property for capitalization rules. Treas. Reg. § 1.263(a)-4(c)(1)(vi), -4(d)(3). But definitions of real property in other areas of tax law include leases. I.R.C. § 897(c)(6); Treas. Reg. § 1.1250-1(e)(3)(i); Treas. Reg. § 1.263A-8(c)(1).

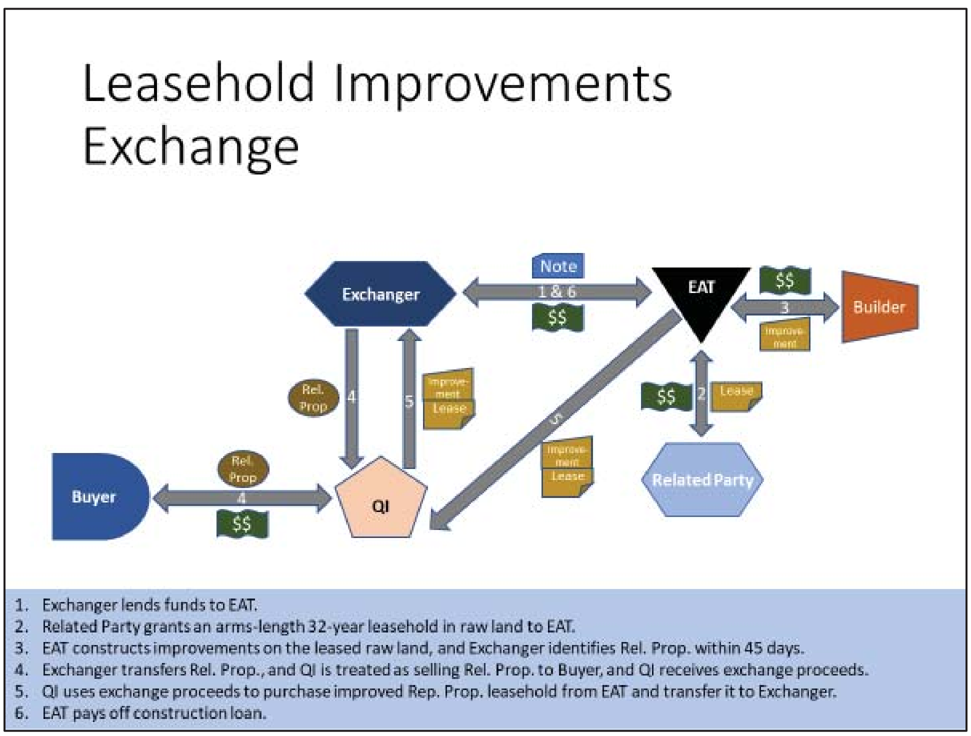
Even if a lease comes within the definition of real property, it must be like-kind to the exchange property to qualify for section 1031 tax-free treatment. The regulations provide that a leasehold in real property of at least 30 years is like kind to general interests in real property (i.e., land and improvements), but a leasehold in real property of less than 30 years probably is not like kind to general interests in real property. Standard Envelope Manufacturing Co. v. Commissioner, 15 T.C. 41 (1950); Capri, Inc. v. Commissioner, 65 T.C. 162 (1975). Such leases could, however, be like kind to other leases of similar length. Rev. Rul. 76-301, 1976-2 C.B. 241.

XI. Leasehold Improvement Situation

The leasehold improvement exchange is one of the most creative and useful exchange structures. Yet, many people are not aware of its availability. Such exchanges make sense when a property owner would like to sell property tax free and use the sale proceeds to construct improvements on other raw land the property owner holds. To qualify for section 1031 tax-free treatment, the transaction must be an exchange and the property acquired must be real property that is like-kind to the transferred property. The transaction must also properly address the related-party rules, if relevant.

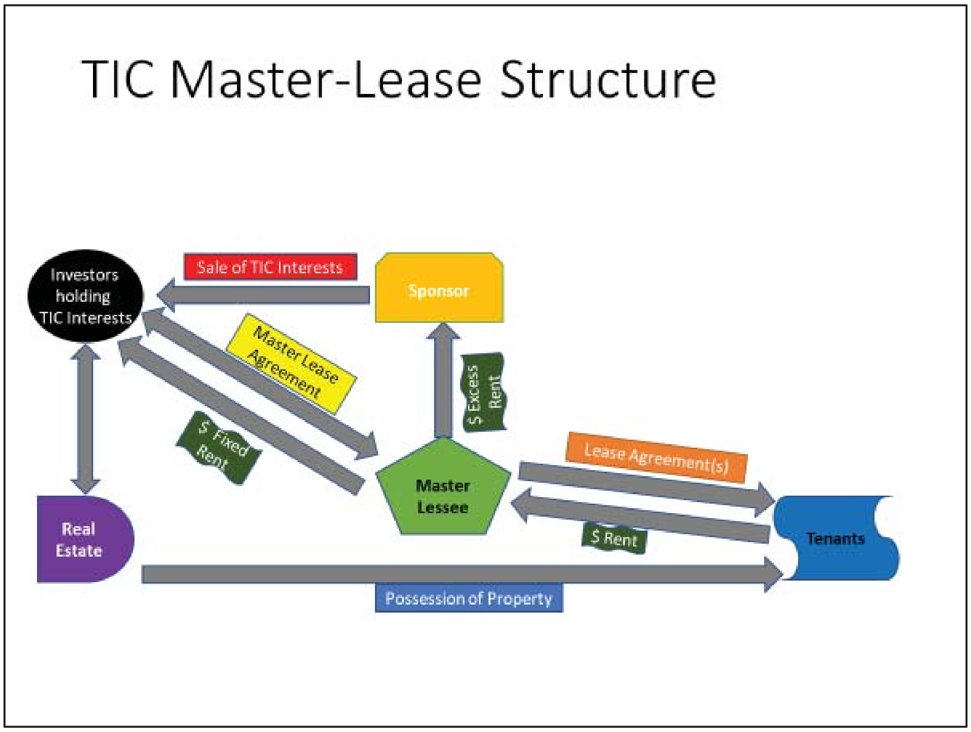
Property that property owner already owns is not eligible for a leasehold improvement exchange. An exchange requires a reciprocal transfer of property. Treas. Reg. § 1.1002-1(d). Therefore, a person cannot acquire already-owned property as part of an exchange, transfer of the property to an accommodation titleholder, and thereby cleanse the pre-owned status. Rev. Proc. 2004-51, 2004-2 C.B. 294. Another party, including a related party, must own the property for at least 180 days prior to the exchange to cleanse pre-owned status, but beware of the related party exchange rules.

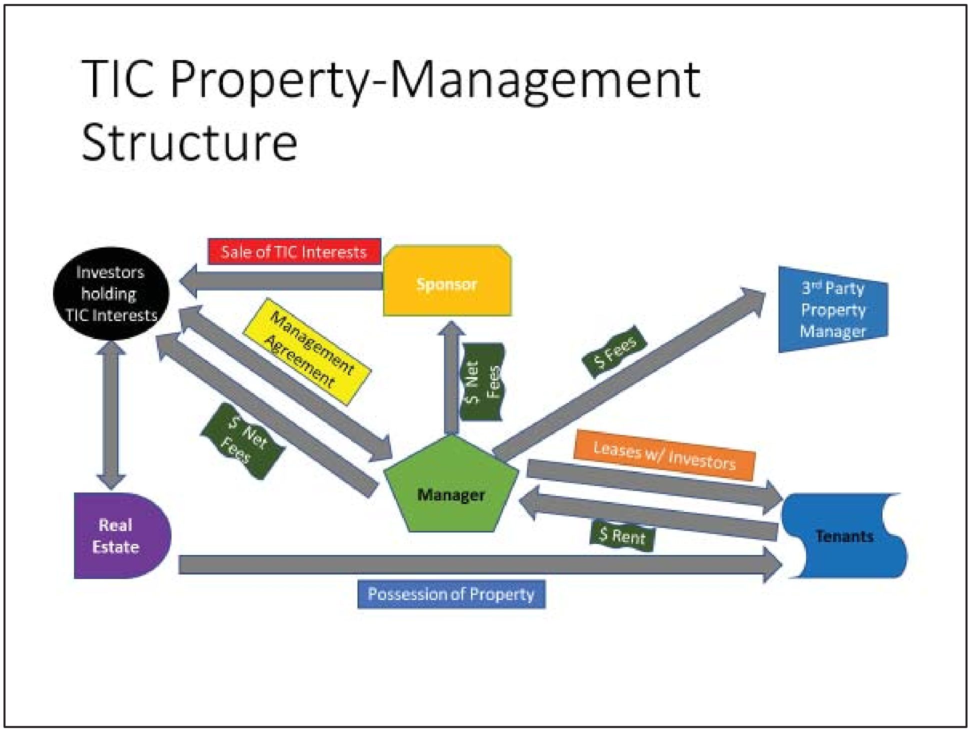
With those hurdles in mind, a property owner may try a leasehold improvements exchange. The property owner avoids building on its property by causing a related party to lease the raw land to an accommodation titleholder. While the accommodation titleholder is the lessee, the property owner directs the accommodation titleholder to construct improvements. Once the improvements are constructed, the accommodation titleholder transfers the leasehold to the property owner to complete the exchange. The IRS approved a leasehold improvement exchange in PLR 200251008, and it approved a similar structure in PLR 200329021. The diagram illustrates the leasehold improvements exchange.



XII. Use of Leases in TICs and DSTs (Lease as "Blocker")

Tenancy-in-common arrangements (TICs) and Delaware statutory trusts (DSTs) find use in the section area because property owners desire to directly own interests in real property instead of owning interests in a partnership. For members of TICs and DSTs to be treated as owning direct interests in the property, the TIC or DST cannot be classified as a partnership for tax purposes. The question of whether a TIC or DST is a tax partnership generally is a challenging question. To steer clear of partnership classification, TICs and DSTs must refrain from conducting business activity. Many such structures use master-lease arrangements to pass the management activities down to the master lessee and limit activity at the TIC and DST level to interacting with the master-lessee. The following diagrams illustrate the difference between a TIC with direct management of the property and one with a master-lessee.





The lease in the master-lease structure becomes a "blocker," blocking the activities associated with managing the property and working with tenants from being attributed to the TIC owners, if structured properly.

Basic and Non-Basic Tax Tips for Leasing Lawyers

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Presentation Overview

- Tax basics of leasing
- Section 467 leases
- Tax treatment of tenant improvement costs
- Identifying the party entitled to depreciation deductions in a ground lease of improved property
- When is a lease a sale and vice versa?
- End of synthetic leases?
- REIT rents problems
- Tax treatment of lease termination payments
- Use of leases in land-building splits
- Exchanging leases under new Section 1031
- Leasehold improvements exchanges
- Lease arrangements in TICs and DSTs

Tax Basics of Leasing

- Lessor has income when rent payment received
  - Rent is ordinary income
    - I.R.C. § 61(a)(5)/451
- Lessee cannot deduct prepaid rent currently
  - Must capitalize and deduct over life of lease
  - Rent is deductible against ordinary income (assuming property is used in trade or business)
    - I.R.C. § 263/Treas. Reg. § 1.263(a)-4
    - Treas. Reg. § 1.162-11 (aliquot share of purchase price of lease each year over life of lease)

- Rules create asymmetry
  - Lessor has income when rent payments received
  - Lessee must defer deductions

- Lessor-lessee tension
  - Lessee wants current deduction
  - Lessor wants to defer income recognition

Examples of Lessor-Lessee Tax-Reporting Mismatch and Tension

General Tax Treatment of Prepaid Rent					
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Payment	$900,000	$0	$0	$0	$0
Lessor Gross Income	$900,000	$0	$0	$0	$0
Lessee Deduction	$180,000	$180,000	$180,000	$180,000	$180,000

General Tax Treatment of Deferred Rent					
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Payment	$0	$0	$0	$0	$900,000
Lessor Gross Income	$0	$0	$0	$0	$900,000
Lessee Deduction	$180,000	$180,000	$180,000	$180,000	$180,000

Section 467

- Section 467 designed to eliminate mismatch caused by tax accounting rules
  - Require/allow lessee to deduct rent payments when lessor recognizes income
  - Enacted to help prevent abuse
    - Lease with "backloaded" or "stepped" rents
    - Accrual method lessee gets current deductions
    - Cash method lessor defers income recognition until later in lease
- Congress leverages lessor-lessee tension
  - Lessor and lessee self-police tax reporting
  - Lessor and lessee create rental accrual schedule that does not necessarily track payments of rent
  - Lessor and lessee must recognize tax aspects of rent payments at the same time
    - Lessor recognizes rental income at same time lessee takes deduction
- Self-policing mechanism breaks down if the parties' tax situations differ
  - Tax-exempt lessor (doesn't worry about front-loaded rent)
  - Lessee with considerable current losses (doesn't need current deduction)
- If section 467 applies
  - Lessor and lessee must treat rents consistently
  - Lessor and lessee must use accrual method of accounting, regardless of overall method of accounting

Applicability of Section 467

- Applies to “section 467 rental agreements”
  - Lease of tangible property

    and
  - Rental terms
    - Uneven rents (increasing or decreasing)

      or
    - Prepaid or deferred rent
  - Provides for total rent of more than $250,000

- If section 467 applies, one of the section 467 rental accrual methods determines the amount of the lessor’s rental income and the lessee’s rental deduction for any taxable year

Section 467 Rental Accrual Methods

- Constant rental accrual method
  - Treas. Reg. § 1.467-1(e)(2)(i), -3
- Proportional rental accrual
  - Treas. Reg. § 1.467-1(e)(2)(ii), -2
- Rental agreement accrual
  - Treas. Reg. § 1.467-1(e)(2)(iii)

Section 467 Constant Rental Accrual Method

- Disqualified long-term agreement or leaseback
  - Leaseback if lessee held interest in property within two years prior to lease
  - Long-term lease if lease term exceeds 75% of the property's statutory recovery period
    - Real estate has a recovery period of 19 years for section 467
    - 19 × 75% = 14.25
      - All leases with terms exceeding 14.25 years are long-term under this definition
- Disqualified
  - Principal purpose for providing increasing or decreasing rent is the avoidance of federal income tax
  - IRS Commissioner determines the lease should be disqualified because of the tax avoidance purpose
    - Only IRS Commissioner can apply
      - Enforcement sword
      - Not a shield for taxpayers
- Creates a section 467 loan

Application of Constant Rental Accrual Method

- Tax avoidance
  - Reasonable expectation of significant difference between the marginal tax rates of the lessor and lessee at some time during lease term
  - Leads to close scrutiny of agreement
  - Need clear and convincing evidence to show tax avoidance not a principal purpose
- If IRS finds tax avoidance, it uses 3-step method to determine constant rental amount
  - Step 1: determine present value of amounts payable under disqualified lease
  - Step 2: determine present value of $1 to be received at end of each rental period
  - Step 3: divide Step 1 amount by Step 2 amount

Reasonable Expectation of Significant Difference in Marginal Tax Rates

- Rental agreement has increasing rents
  - Lessors marginal tax rate
    is expected to be greater than
  - Lessee's marginal tax rate + 10 percentage points
- Rental agreement has decreasing rents
  - Lessee's marginal tax rate
    is expected to be greater than
  - Lessor's marginal tax rate + 10 percentage points

Examples of Possible Significant Difference in Marginal Tax Rates

- Lessor is tax-exempt entity, taxable lessee has significant income
  - Lease provides for decreasing rents
    - Lessor does not pay tax on prepaid rent
    - Lessee benefits from current deductions
- Lessee has current and projected operating losses, lessor has significant income
  - Lease provides for increasing rents
    - Lessor benefits from deferral of income recognition
    - Lessee is indifferent about not getting deductions currently

Computation of Constant Rental Amount

- Disqualified sale-leaseback (lessor has higher tax rate)

Schedule of Rent Payments due under Agreement					
	Year 1	Year 2	Year 3	Year 4	Year 5
Rent	$0	$0	$0	$17,500,000	$17,500,000

  - Step 1: present value of rent payments = $21,051,536
    - Assumption: 12% discount rate
  - Step 2: present value of $1 received at end of each rental period = $3.6047762
  - Step 3: $\frac{\$21{,}051{,}536}{\$3.6047762} = \mathbf{\$5{,}839{,}901}$ (fixed rent for each rental period)
- Lessor must report $5,839,901 as gross income for each year of lease
- Lessee may deduct $5,839,901 as rent expense for each year of lease

Safe Harbor from Constant Rental Amount

- Tax avoidance not a principal purpose for increasing or decreasing rents if
  - Meet uneven rent test
    - Amount of rent allocated to each calendar year is within 10 percent of the average rent for all calendar years
  - Increase or decrease in rent is wholly attributable to one or more of the following
    - A contingent rent provision
    - A single rent holiday allowing reduced rent for one consecutive period of the lease
      - For three months or less
      - Reasonable, as determined by reference to commercial practice
      - Does not exceed lesser of 24 months and 10 percent of lease term

Section 467 Proportional Rental Accrual Method

- Only applies if rental agreement is not subject to constant rental accrual method
  - Section 467 rental agreement is not a disqualified leaseback or long-term agreement
- Rental agreement provides for
  - Does not provide for adequate interest
- Generally, applied if payment schedule under the lease is different from the accrual schedule
- Creates a section 467 loan

Adequate Interest on Rent

- Adequate interest on fixed rent
  - No deferred or prepaid rent
  - Deferred or prepaid rent, and
    - Rental agreement provides for interest on deferred or prepaid rent at a single rate
    - Stated rate of interest is no lower than 110% of AFR
    - Amount of deferred and prepaid fixed rent adjusted at least annually to reflect amounts paid and owing
    - Rental agreement requires interest to be paid or compounded at least annually
  - Other agreements
    - Deferred, but no prepaid, rent
      - Sum of present value of all amounts payable by lessee as fixed rent is greater than or equal to the sum of the present value of the fixed rent allocated to each rental period
    - Prepaid, but no deferred, rent
      - Sum of present value of all amounts payable by lessee as fixed rent, plus the sum of the negative present values of all amounts payable by the lessor as interest, if any, on prepaid fixed rent, is less than or equal to the sum of the present value of fixed rent allocated to each rental period
- Section 467 rental agreements with variable interest
  - Use fixed rate substitutes
- Agreement with both deferred and prepaid rent
  - Satisfy the requirements of a rental agreement with deferred or prepaid rent
  - Single fixed rate of interest on deferred rent
  - Single fixed rate of interest on prepaid rent
  - Rates of interest can differ

Computation of Proportional Rental Amount

- For rental agreements that are not disqualified and do not provide for adequate interest the proportional rental amount is the amount of rent allocated to rental period multiplied by the following fraction:

$$\frac{present\ values\ of\ amounts\ payable + interest}{present\ values\ of\ fixed\ rents\ allocated\ to\ each\ period}$$

Application of Proportional Rental Accrual Method

- Rent schedule in agreement

Schedule of Rent Allocated and Payments due under Agreement			
	Year 1	**Year 2**	**Year 3**
Rent Allocation	$800,000	$1,000,000	$1,200,000
Rent Payment	$0	$0	$3,000,000

- Agreement does not state adequate interest
  - Has deferred rent
  - Does not provide for interest at a fixed rate
  - Present value of payments not greater than or equal to present value of allocated rents (assuming 8.5% discount rate)
    - Present value of amounts payable = $2,348,724
    - Present value of allocated rents = $2,526,272
- Fraction = $2,348,724/$2,526,27 = .9297294
- Section 467 rent for each year
  - Year 1: $800,000 × .9297194 = $743,776
  - Year 2: $1,000,000 × .9297194 = $929,729
  - Year 3: $1,200,000 × .9297194 = $1,115,663
- Parties must also account for interest on the section 467 loan

Section 467 Loans

- Section 467 loan exists if rent is determined using either constant rental accrual method or proportional rental accrual method
  - I.e., the amount of fixed rent stated in the agreement differs from the amount determined under one of those methods
- Positive section 467 principal balance
  - Loan from lessor to lessee
    - Lessor is lending lessee accrued unpaid rent
  - Lessor has interest income
  - Lessee has interest deduction
- Negative section 467 principal balance
  - Loan from lessee to lessor
    - Lessee is lending lessor prepaid rent
  - Lessee has interest income
  - Lessor has interest deduction

Computation of Section 467 Loan

Amount of 467 loan = Fixed rent accrued in preceding years + (lessor's interest income for preceding years + interest payable to lessor on or before first day) – (lessee's interest in income on prepaid fixed rent for prior rental periods + amount payable to lessor before first day as interest)

- Example from proportion accrual method

Schedule of Rent Allocated and Payments due under Agreement			
	Year 1	**Year 2**	**Year 3**
Rent Allocation	$800,000	$1,000,000	$1,200,000
Rent Payment	$0	$0	$3,000,000
467 Rent	$743,776	$929,729	$1,115,663

Amount of 467 Loan + Interest (assume 8.5% yield)			
	Year 1	**Year 2**	**Year 3**
Accrued Fixed Rent (beginning)	$0	$743,776	$1,736,726
Lessor's Interest Inc.	$0	$63,221	$147,622
Interest Payable to Lessor	$0	$0	$0
Lessee's Interest	$0	$0	$0
Amount Payable to Lessor	$0	$0	$0
Outstanding Loan Balance	$0	$806,997	$1,884,348
Ending Loan Balance			$3,000,000

Section 467 Rental Agreement Accrual Method

- Only applies if lease not subject to constant rental accrual method or proportional rental accrual
- Follow accrual schedule in rental agreement
- If there is no specific allocation, the amount of rental allocated to a rental period is the amount of fixed rent payable during that rental period

Depreciation Deductions Related to Leased Property

- General rule: owner of property gets depreciation deductions
  - Lessor typically gets depreciation deductions for improvements lessor constructs on leased property
  - Lessee typically gets depreciation deductions for tenant improvements
  - Look to who invested capital in the improvements
- Lessee improvements
  - Lessee improvements excluded from lessor's income upon lease termination
    - I.R.C. §§ 109, 1019
  - Lessee must capitalize cost of lessee improvements
    - I.R.C. § 263
  - Lessee or lessor capitalizes and depreciates cost of improvements over applicable MACRS recovery period—not life of lease
    - I.R.C. § 168(i)(8)(A)
- Tenant improvements as substitute for rent
  - Lessee improvements are in lessor's income, if a substitute for rent
  - Lessee can deduction cost of rent-substitute improvements currently
    - Hopkins Partners v. Comm'r, 97 T.C.M. (CCH) 1560 (2009); Treas. Reg. § 1.109-1

Lease vs. Sale/Financing

- Tax law can disregard the form of a transaction
  - Transaction cast as a lease can be a seller-financed sale from the lessor to the lessee in substance
  - Transaction cast as a debt-financed purchase by the user could be recast as a purchase by the "lender" and lease to user
- Party that holds the benefits and burdens is the tax owner
  - Factors
    - How do the parties treat the transaction?
      - Rent payments or debt service and interest?
      - Lessor recognize gain upon entering into the lease?
      - Which party is claiming depreciation deductions?
    - Does the lessor have an equity interest in the property?
      - Will the property have any economic value at the end of the lease term?
      - Does lessee have option to purchase at below market at end of lease term?
      - Does the lessor have a present obligation to transfer title to the property?
    - Who bears the risk of loss?
    - Who owns the upside?
- *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Torres v. Commissioner*, 88 T.C. 702, 720-722 (1987); *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237-1238 (1981); *Estate of Thomas v. Commissioner*, 84 T.C. 412, 433-436 (1985)

Lease vs. Partnership

- Partnership under state law: “an association of two or more persons to carry on as co-owners a business for profit”
  - Is “rent” based upon lessee’s profits?
    - Different if gross receipts?
  - Who controls the ultimate disposition of the property?

- Question of whether a partnership exists is one of the most difficult questions in partnership tax, if a situation raises the question
- Question is matter of federal tax law, so state law classification is not determinative

Synthetic Leases

- Financing structure
  - Short-term lease (<10 years, including renewal options)
  - Purchase options
  - Rights of termination
  - Relevant to taxpayers who prepare GAAP financial statements
  - Used for assets such as corporate headquarters or real estate projects, or corporate aircraft
- For tax purposes, the user is deemed to borrow and buy property
  - User has the benefits and burdens
  - User gets the depreciation deductions
- For GAAP purposes the user is deemed to enter into an operating lease with the "lender"
  - Operating lease keeps the obligation for rent payments off the balance sheet
- Recent accounting changes will require lessees to record a lease liability for synthetic leases, so benefit of off-balance sheet finance will be lost
  - Popularity may diminish

REITs and Rents

- REIT income tests require that 95% (passive type income) and 75% (income from real property) of the REIT's gross income derive from specific sources, including
  - Rents from real property

- Rents from real property
  - Must be real property
    - Numerous rulings and recent regulations
  - Must be rent
    - Cannot be from services provided to tenants, other than customary services
  - Non-customary services can be provided to tenants by
    - Independent contractors
    - Taxable REIT subsidiaries

Tax Treatment of Lease Termination Payments

- Treatment of termination fee paid from lessee to lessor
  - Ordinary income to lessor
    - Hort v. Comm’r, 313 U.S. 28 (1941)
    - Treas. Reg. § 1.61.8(b)
  - Lessee should be able to currently deduct fee
    - Cassatt v. Comm’r, 137 F.2d 745 (3d Cir. 1943)
- Treatment of termination fee paid from lessor to lessee
  - Lessor must capitalize fee, Treas. Reg. § 1.263(a)-4(d)(7)(i)(A)
    - Add to basis of the property
    - Recover over unexpired term, or
    - Recover over another lease the lessor enters into
      - Handlery Hotels, Inc. v. United States, 663 F.2d 892 (9th Cir. 1981)
  - Lessee treats payment as an amount received in exchange for selling the lease
    - I.R.C. § 1241

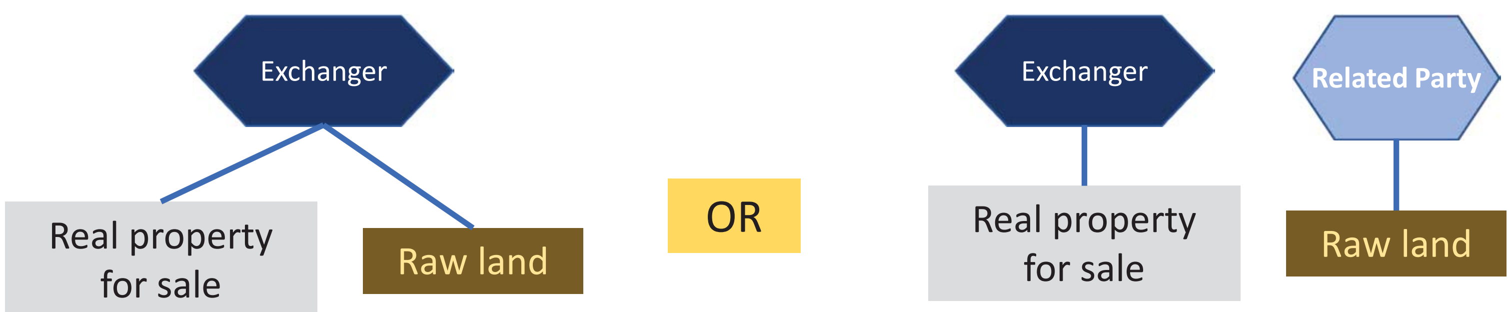
Use of Leases in Land-Building Splits

- Land-building split: owner of improved property transfers title to building and retains land
  - Purchaser of building uses lease for access to the land
- Indicia of lease, but no transfer of building (unsuccessful splits)
  - Lessee required to restore destroyed building
  - Lessee must post bond equal to demolition and construction costs to replace existing building
  - Lessee required to insure building
  - Recovery from loss of building paid to lessor
  - Lessee must maintain the building in good condition
  - Title to building reverts to lessor when lease terminates
  - Lessee is not permitted to sever or remove the buildings
    - Gates v. Helvering, 69 F.2d 277 (8th Cir. 1934); Lindley's Trust No. 1 v. Comm'r, 120 F.2d 998 (8th Cir. 1941); Crile v. Comm'r, 55 F.2d 804 (6th Cir. 1932); Estate of Budd Frankenfield v. Comm'r, 17 T.C. 1304 (1952); Minneapolis Syndicate v. Comm'r, 13 B.T.A. 1303 (1928).
- Successful land-building splits
  - Condominium sales
    - Lessee has right to remove at end of ground lease
    - Lessor had to acquire units that were not removed at end of the lease
    - Owner of improvements would receive proceeds from condemnation
      - Rev. Ru. 70-607, 1970-2 C.B. 9
  - Right to remove building strong indication of split
    - Waldrep v. Comm'r, 52 T.C. 640 (1969)
  - Right to remove building and right to insurance proceeds indicia of split
    - Bratton v. Rountree, 37 A.F.T.R.2d 76-762 (M.D. Tenn. 1976)

Exchanging Leases under New Section 1031

- Section 1031 requires relinquished and replacement property to be real property and like kind
- Leasehold of a fee with 30 years or more to run is like kind to real estate
  - Treas. Reg. § 1.1031(a)-1(c)(2)
- Is a leasehold in real property real property under section 1031?
  - Recognized as intangible personal property for capitalization rules
    - Treas. Reg. § 1.263(a)-4(c)(1)(vi), -4(d)(3)
  - Comes within definition of real property
    - I.R.C. § 897(c)(6); Treas. Reg. § 1.1250-1(e)(3)(i); Treas. Reg. § 1.263A-8(c)(1)
  - Treated as real property for like-kind requirement
- Leasehold in real property of less than 30 years
  - Probably not like kind to fee
  - Maybe like kind to other lease with similar length
    - Check definition of real property

Leasehold Improvement Situation



Objective

- Exchanger would like to use the proceeds from the sale of its property to construct improvements on the raw land
- Exchanger wants 1031 nonrecognition

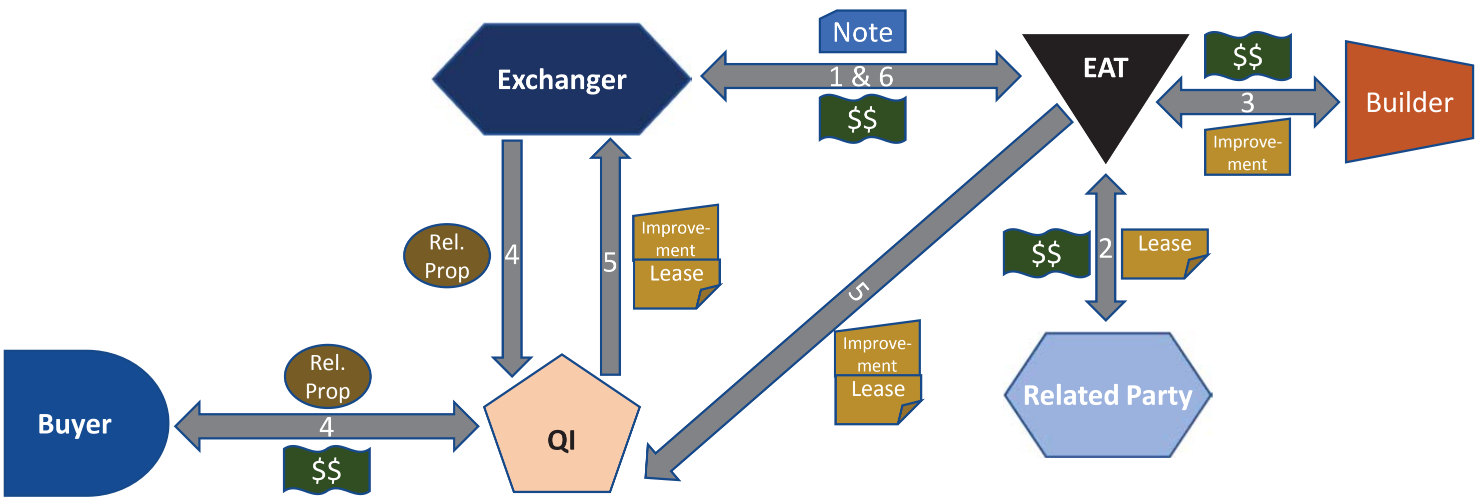
Relevant Section 1031 Elements

- Keys to improvement exchanges
  - Like Kind
  - Real Property
  - Exchange
- Related-Party Rules

Planning Strategy

- Avoid building on already-owned property
  - Use related party's property
- Avoid basis shifting and cashing out
  - Ensure that improvements, not already-owned property, are the replacement property

Leasehold Improvements Exchange



1. Exchanger lends funds to EAT.
2. Related Party grants an arms-length 32-year leasehold in raw land to EAT.
3. EAT constructs improvements on the leased raw land, and Exchanger identifies Rel. Prop. within 45 days.
4. Exchanger transfers Rel. Prop., and QI is treated as selling Rel. Prop. to Buyer, and QI receives exchange proceeds.
5. QI uses exchange proceeds to purchase improved Rep. Prop. leasehold from EAT and transfer it to Exchanger.
6. EAT pays off construction loan.

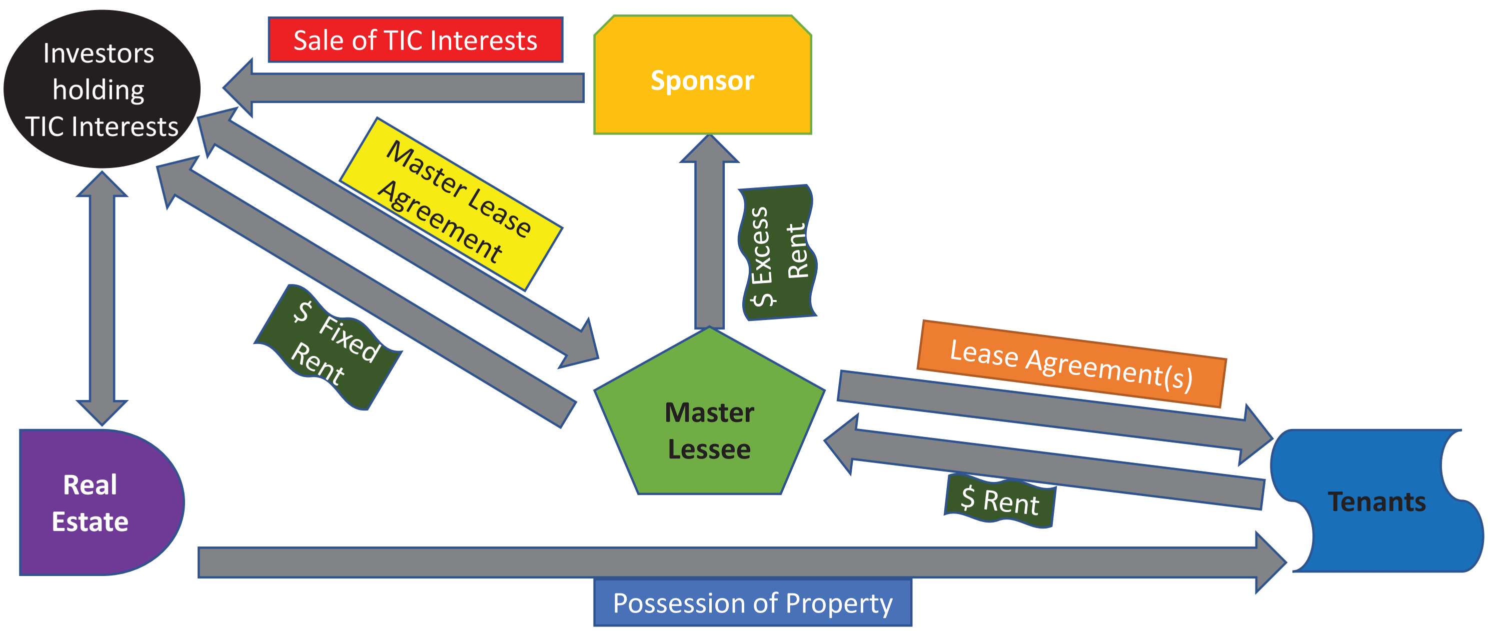
I.R.S. Approved Leasehold Improvement Exchange

- IRS approved leasehold improvement exchange in PLR 200251008
  - Unrelated party owned fee
  - Related party had a 45 year ground sublease
  - Related party subleased property for 32 years to EAT to make improvements
  - Within 180 days EAT transferred leasehold and improvements to exchanger
- IRS approved similar structure in PLR 200329021
  - Related party owned long term lease of property
  - Related party assigned the lease to the EAT to make improvements
  - EAT assigned leasehold and improvements to exchanger
  - IRS approved, but required each party to hold for two years

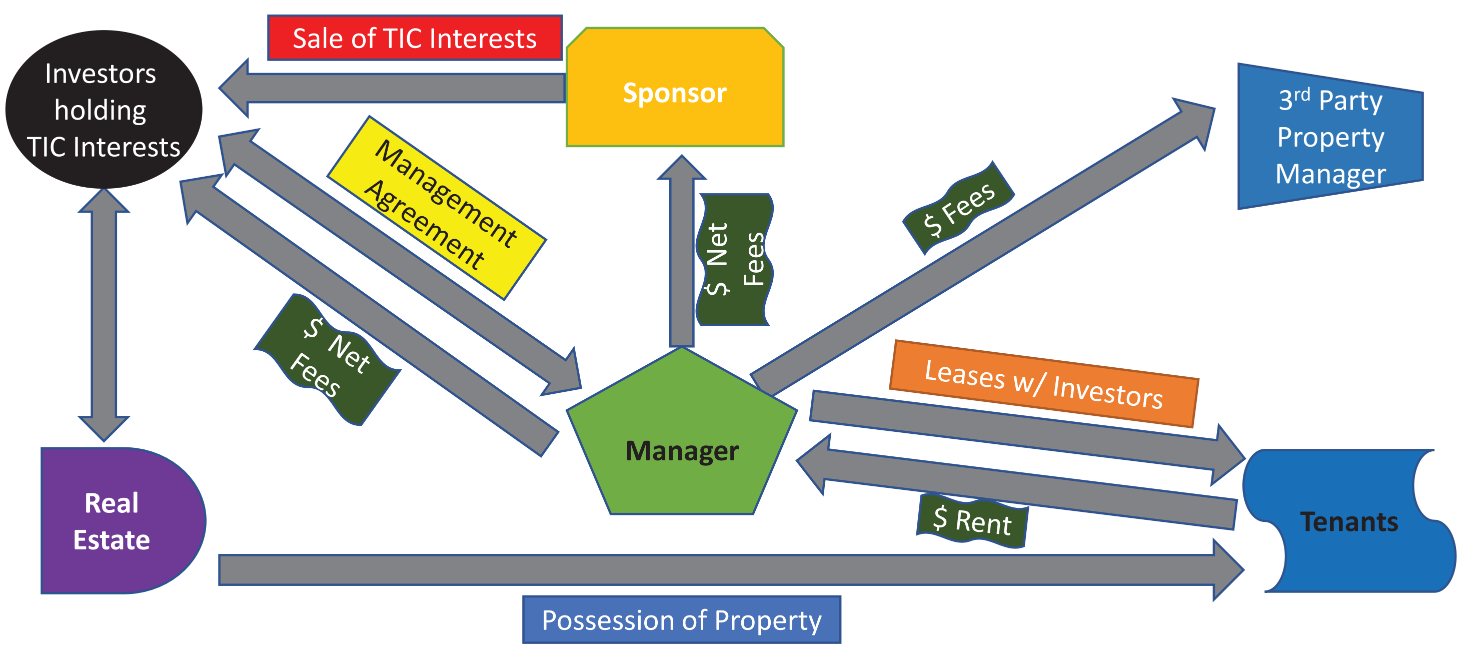
Use of Leases in TICs and DSTs

- Leases can help TICs and DSTs avoid being classified as tax partnerships

TIC Master-Lease Structure



TIC Property-Management Structure



Faculty Biographies

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Professor Borden's research, scholarship, and teaching focus on taxation of real property transactions and flow-through entities (including tax partnerships, REITs, and REMICs). He teaches Federal Income Taxation, Partnership Taxation, Taxation of Real Estate Transactions, and Unincorporated Business Organizations, and he is affiliated with the Dennis J. Block Center for the Study of International Business Law. His work on flow-through and transactional tax theory appears in articles published in law reviews including Baylor Law Review, University of Cincinnati Law Review, Florida Law Review, Georgia Law Review, Houston Law Review, Iowa Law Review, Tax Lawyer, and Virginia Tax Review, among others. His articles also frequently appear in leading national tax journals including Journal of Taxation, Journal of Taxation of Investments, Real Estate Taxation, and Tax Notes.

Professor Borden is the author or co-author of several books, including Federal Income Taxation (Foundation Press, 7th ed. 2017) (with Daniel L. Simmons, Martin J. McMahon, Jr. & Dennis J. Ventry, Jr.), Federal Taxation of Corporations and Corporate Transactions (Aspen Publishers, in progress), Limited Liability Entities: a State by State Guide to LLCs, LLPs, and LPs (Wolters Kluwer Law & Business 2012, with seven annual updates), Tax-Free Like-Kind Exchanges (Civic Research Institute, 2nd ed. 2015), Taxation and Business Planning for Partnerships and LLCs (Aspen Publishers, 2017), and Taxation and Business Planning for Real Estate Taxation (LexisNexis, 2011, Carolina Academic Press, 2nd ed. 2017). The U.S. Court of Appeals for the Fifth and Ninth Circuits, the U.S. Court of Federal Claims, state judicial bodies, and federal and state bar associations have cited Professor Borden's work in their opinions and publications. He is frequently quoted in leading news publications such as The Los Angeles Times, The National Law Journal, The New York Times, and Reuters and blogs about tax issues for The Huffington Post.

Professor Borden has worked as a consultant to The Joint Committee on Taxation, Congress of the United States and often serves as an expert witness or consultant on major litigation matters that relate to real estate, flow-through taxation or legal malpractice. Before entering academia, he practiced tax law in the San Antonio, Texas law firm of Oppenheimer, Blend, Harrison & Tate, Inc. He is active in the American Bar Association Section of Taxation, is a past chair of its Sales, Exchanges & Basis Committee, and is a fellow of the American College of Tax Counsel.

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Andy Herz is a member of the American College of Real Estate Lawyers and is included in The Best Lawyers in America® and recognized as a leading lawyer in Chambers USA as a key member of our highly rated real estate department. Specifically, Chambers notes that ‘the "terrific," "excellent" and "very capable" Andrew Herz has "developed a great reputation for himself" as “a seasoned real estate practitioner” in the New York market. Contemporaries state that they would refer leasing matters to him "without a shadow of a doubt."’ Clients have stated that he is "an incredible leasing lawyer, probably the best in the city in terms of leasing." He has also been designated as one of only 32 real estate lawyers in the world to be included in the 2017 edition of The Best of the Best in Real Estate published by Legal Media Group. He has been an adjunct professor at both Vanderbilt Law School and Brooklyn Law School where he taught intensive commercial real estate law courses. For the past fourteen years, Mr. Herz has been a member of the Advisory Board and presenter at Georgetown University's Advanced Commercial Leasing Institute. His clients include major real estate owners and developers, hedge funds, technology providers, hospitals, professional service companies, charitable institutions and other law firms.

Andy Herz received the 2016 New York Bar Association’s Real Property Law Section Professionalism Award for his “exceptional contributions of time and talent to New York real estate lawyers.” The award identifies a person “possessing an outstanding level of competence, legal ability and achievement; a continuing civility and appreciation for others in his/her practice; a person who has engaged in mentoring of younger attorneys and who has been involved in Bar activities both on a state and local level.”

EDUCATION

Columbia Law School (J.D., 1971)
Harlan Fiske Stone Scholar
Articles Editor, Columbia Journal of Law and Social Problems
Columbia College, Columbia University (B.A., 1968)

Nina L. Kampler, Esq.
President, Kampler Advisory Group LLC
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Nina Kampler has more than 30 years of industry experience as a retailer, a lawyer, a broker, a restructuring advisor and a business development expert. She formed Kampler Advisory Group in 2012 to provide opportunistic value-add advisory services to the retail real estate industry.

From 2010 through 2012, she was Senior Managing Director of CBRE's Retail Services Group, managing the New York Tri-State retail brokerage platform and heading the Urban Retail Group in the Americas, integrating the high-street retail practice across the US with the practice groups in Europe.

Prior to CBRE, Ms. Kampler served as Executive Vice President for Hilco Real Estate from 2004 to 2010. She directed their strategic retail and corporate solutions group and led retail business development. Ms. Kampler collaborated with major national and international retailers and commercial companies to implement real estate portfolio restructuring strategies and includes Starbucks, Tumi, and GEOX, amongst her clients.

Previous to that, she spent 16 years at Polo Ralph Lauren Corporation, serving as their Vice President, Retail and Real Estate Counsel. In that capacity, she negotiated all store and corporate real estate transactions throughout the U.S. and Canada. She also held the position of acting General Counsel for Club Monaco.

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Danielle serves as the Chair of the Business Litigation Department. Danielle is an experienced trial attorney whose diverse practice involves all phases of litigation, from pleading through verdict and appeal. Danielle's practice includes both litigating and advising transactional clients with respect to litigation risk and litigation avoidance strategies.
Danielle has successfully handled a broad range of litigations in state and federal court as well as in arbitrations and is often retained on the eve of trial. Danielle's representations include public companies, multi-million dollar private companies, hedge funds, private equity funds, investment bankers, start-ups, developers, real estate companies, information and technology companies, high net worth individuals, and partnerships in all types of business disputes, ranging from restructuring, hotel and hospitality, real estate, and contract disputes to enforcement of restrictive covenants.

Professional Activities

American Bar Association
New York City Bar Association
Associate Member, New York City Bar Association Judiciary Committee
Member, New York State Bar Association, Committee On Women in the Law
Member, New York Supreme Court Appellate Division, First Department, Departmental Disciplinary Committee
Judicial Committee, "Program for State and Federal Judges on the Judicial Role in Selecting and Appointing of Fiduciaries, Monitors, Masters, and other Judicial Adjuncts," April 21, 2015
Chair, Women In the Law Committee, Federal Bar Association, Southern District of New York Chapter
"Pass the Torch" — Ceremony Congratulating Chief Judge Loretta Preska and Judge Colleen McMahon of the SDNY, April 20,2016
"Meet the Chiefs" — Honoring the Four Women Chief Judges of SDNY and EDNY, March 4, 2015
Federal Bar Association, Southern District of New York Chapter
Board Member, The Webster Apartments, a non-profit residence for working women and students
New York Regional Leadership Council, The One Love Foundation

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Owner
Law Office of Bruce J. Leuzzi
Jan 1999 – Present | 19 yrs 9 mos
Bruce J. Leuzzi's law practice is focused on commercial real estate transactions: acquisition and sale of properties (including office buildings, loft buildings, multi-family buildings and ground leases), ground leases (representing landlords and tenants), acquisition and sale of development rights, leasing (representing landlords and tenants, including office leases, loft leases and retail leases), and financing (representing borrowers in financing and refinancing, and construction financing).

Bruce was admitted to the New York State Bar in 1989.

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Janice Mac Avoy is a member of the Real Estate Department and the Litigation Department, co-chair of the Real Estate Litigation Practice Group and co-chair of the Firm's Pro Bono Committee.

Ms. Mac Avoy concentrates her practice in complex real estate-related transactions and disputes, commercial litigation and arbitration, complex commercial landlord tenant disputes and commercial fair market rent arbitrations. She also has extensive experience in creditor's rights, including complex commercial real estate mortgage foreclosures and UCC foreclosures, workouts and restructuring of real estate secured debt. Ms. Mac Avoy works with the Firm's Real Estate Department on transactions in order to resolve issues without resorting to litigation.

Among Ms. Mac Avoy's recent noteworthy representations are:

- Normandy Real Estate Partners in its sale and acquisition of 575 Lexington Avenue.
- Richard Cohen of Capital Properties in the successful defense of a claim by a lender under a non-recourse carve-out guaranty.
- Princeton Holdings LLC in the successful arbitration of a dispute regarding the acquisition of a 50% tenant-in-common interest in the Ring Portfolio -- 14 Manhattan properties, valued in excess of US$450 million at the time of the agreement and currently worth significantly more.
- RBC in its foreclosure action and subsequent restructuring of debt on the iconic Lipstick Building in New York City.
- Lehman Brothers in connection with several foreclosure actions, including a significant development site adjacent to Hudson Yards in New York City.
- Blackstone in a potential ground lease rent reset arbitration that was successfully negotiated with the landlord without the need to resort to arbitration.

Eric G. Menkes, Esq.
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Eric Menkes was one of the first partners in the real estate department at Duval & Stachenfeld. His primary area of expertise is commercial leasing, and he heads the firm's Leasing Practice Group. He is familiar with virtually all aspects of commercial leasing, representing landlords and tenants, in office, retail, ground lease, industrial and triple-net transactions, as well as sublease transactions. Eric has particular expertise in retail leasing, representing shopping center and street retail owners, as well as national and international retailers.

Significant retail projects include the leasing of Wynn Plaza, a luxury shopping center developed in conjunction with Crown Acquisitions adjacent to the Wynn and Encore Hotels in Las Vegas; the Showcase Mall, also in Las Vegas; the retail space at 680 Madison Avenue in New York (the former Carlton House); and 750 Seventh Avenue (the former Lehman Brothers headquarters). Current and prior retailer clients include Prada, Nike/Converse, Polo Ralph Lauren, Gucci Group; Circuit City, Kmart and H&M.

Office projects include the leasing of Industry City, a 6,000,000 square foot development in Sunset Park, Brooklyn catering largely to technology tenants, the Falchi Building and Standard Motor Products Building in Long Island City; the office buildings at 1250 Broadway, 530 Fifth Avenue and 450 West 15th Street in New York; 1801 K Street (the Federal Reserve Building) in Washington, DC and Citadel Center in Chicago. Landlord clients include RXR, Jamestown, Angelo, Gordon & Co., Belvedere Capital, Extell Realty, Olmstead Properties and Savanna.

He recently represented Boies Schiller in its headquarters lease at Hudson Yards in New York and has negotiated co-working leases on behalf of WeWork.
Mr. Menkes regularly lectures at International Council of Shopping Center law conferences; he is a contributor to The Practical Real Estate Lawyer; and he has spoken before the Real Property Law Section of the New York State Bar Association. He is former counsel and Chairman of the Board and Counsel for Miracle House of New York, a not-for-profit housing agency.

Hope K. Plasha, Esq.

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Hope K. Plasha has a broad-based real estate practice that includes the representation of landlords and tenants in leasing transactions, owners and developers in the acquisition and construction of commercial and residential properties, investors in the structuring of joint ventures, and lenders and borrowers in a wide-spectrum of real estate financings.

Ms. Plasha serves as primary outside real estate counsel for a global media company in many of its domestic and international property matters. Representative projects include negotiating and restructuring its New York, London, and Hong Kong headquarters leases as well as numerous office and warehouse leases throughout the United States and in 37 different countries (including leases in Beijing, Tokyo, Frankfurt, Brussels, Moscow, Sao Paulo, Mumbai, Johannesburg, and many other locations), assisting in the acquisition and disposition of more than two dozen industrial and warehouse facilities (many with complex environmental issues), negotiating construction and design contracts, drafting easements/right-of-way agreements and addressing land development concerns with government agencies and utility providers, negotiating brokerage, service, and property management contracts with outside vendors, and offering general advice on real estate issues arising in the context of its corporate property portfolio (including with respect to domestic and international M&A).

EDUCATION

Yale Law School (J.D., 1996)
Oxford University, Magdalen College (M.Litt., 1993)
Marshall Scholar
Columbia University, Columbia College (A.B., magna cum laude, 1990)
Phi Beta Kappa

ADMISSIONS

New York

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Keith E. Reich has been practicing law for more than 30 years and concentrates his practice in the area of real estate law. He has wide-ranging experience with commercial leasing, lease and loan restructuring, sales and acquisitions of commercial, industrial and residential properties, ground and net leasing and green building and sustainable development. He also represents lenders and borrowers in mortgage financing and negotiates brokerage, construction and other forms of real estate agreements.

Concentrations

Commercial leasing, representing both landlords and tenants
Sales and acquisitions of commercial, industrial and residential properties
Mortgage financing, representing both lenders and borrowers
Ground and net leasing
Green building and sustainable development practice group
Real estate related bankruptcy matters
Lease and loan restructuring
Negotiation of brokerage, construction and other forms of real estate agreements

Education
- J.D., Boston University School of Law, 1981
- A.B., magna cum laude, Brown University, 1978
- with honors

Admissions
- New York

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Joshua Stein, a member of the American College of Real Estate Lawyers, the American College of Mortgage Attorneys, and the Anglo American Real Property Institute, has wide experience in commercial real estate transactions, development transactions, new and defaults loans, and other real estate matters and disputes. He has handled closings and resolved problems for ground leases, hotels, developments, and space leases. He has represented secured lenders, purchasers, sellers, investors, developers, borrowers, landlords, tenants, leasehold mortgagees, and hotel operators.

Joshua has been engaged as an expert witness, an arbitrator, a mediator, and a court-appointed receiver and referee. His name appears on the New York State Unified Court System Part 36 Fiduciary List for those and other appointments. He is a former chair of the New York State Bar Association's Real Property Law Section, as well as a former co-chair of the Section's Commercial Leasing Committee. Since 1997, Joshua has chaired Practising Law Institute's annual two-day seminar on commercial real estate finance. He speaks regularly before real estate industry and legal audiences and is often quoted in the real estate and business press, but never about his own transactions.

He has published five books: Stein on New York Commercial Mortgage Transactions (LexisNexis 2006); A Practical Guide to Real Estate Practice (ALI-CLE 2001); Lender's Guide to Structuring and Closing Commercial Mortgage Loans (Mortgage Bankers Association 2004; out of print); A Guide to Ground Leases (With Forms and Checklists) (ALI-ABA 2005; out of print); and A Guide to Troubled Commercial Real Estate Loans for Lenders and Borrowers (LexisNexis 2010). He edited and wrote much of the New York State Bar Association's two-volume treatise on Commercial Leasing (in its third edition as of 2017) and has published more than 200 articles, checklists, and other materials on commercial real estate law and practice. An article he wrote on usury won a 2002 Burton Award recognizing clarity and simplicity in legal writing. He is one of the leading writers on commercial real estate law and practice in the United States.

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Joseph P. Heins is Special Counsel in the Business and Corporate Law Department. Mr. Heins concentrates his practice primarily in the areas of real estate, business law, corporate law and wills and estates. He has considerable experience in the commercial real estate sector, including leasing, sales and acquisitions, project development, financing and real property title matters. Mr. Heins has received several honors and awards during his career, including being named a Up and Coming Attorney by the Daily Record in 2015, earning a ranking as an Associate to Watch in Chambers USA in 2017 and 2018, and being listed as a Rising Star in Super Lawyers Magazine in 2016, 2017 and 2018.

State of New York
J.D., Notre Dame Law School
B.S., Canisius College

Professional Associations
Erie County Bar Association
New York State Bar Association
International Council of Shopping Centers
New York State Commercial Association of Realtors

Practice Areas
Real Estate
Business and Corporate Law
Estate Planning
Municipal Law

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Harold A. Kurland is a partner of Ward Greenberg Heller & Reidy LLP, a Rochester-based litigation firm he helped establish, as Ward Norris Heller & Reidy LLP, in 2000. Before then, Mr. Kurland was a member of Nixon Peabody LLP, formerly known as Nixon, Hargrave, Devans & Doyle, which he joined as an associate in 1976. He has had an active litigation and trial practice throughout his professional career. He also frequently serves as a mediator and an arbitrator, and he is a certified mediator for the U.S. District Court mediation panel for the Western District of New York.

Mr. Kurland is a past president of the Monroe County Bar Association (2009-10). He also is a longstanding member of the American Bar Association and the New York State Bar Association, and was a member of the NYSBA House of Delegates. He is immediate past president of the Foundation of the Monroe County Bar.

Mr. Kurland is a fellow of the American College of Trial Lawyers, an associate of the American Board of Trial Advocates, and a fellow of the American Bar Foundation and the New York Bar Foundation. He is a past president and master of the Rochester Inns of Court. He graduated with honors from Dartmouth College in 1973 and Cornell Law School in 1976, where he was article editor of the Cornell Law Review.

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Michael represents companies, developers, landlords, tenants, financial institutions, municipalities, and nonprofit organizations in a wide range of commercial real estate matters, including acquisition, development, financing, leasing, and construction matters.

In connection with his commercial real estate practice, Michael has also counseled clients on:

Acquisition and financing of multi-family housing, including large portfolio transactions.
Construction law matters, regularly representing owners and developers in construction and design contract negotiations.
State and local tax incentive programs, including with industrial development agencies.
Telecommunication leasing, with a focus on representing tenants.
Large-scale energy projects.
Municipal real property transactions.
Real property tax exemptions for not-for-profit corporations.
Michael also has experience representing corporate trustees on the closing of complex bond transactions.

In addition, Michael has experience in bankruptcy matters, loan workouts, and restructurings, with a focus on representing lenders, trustees, special servicers, and other financial institutions.

Prior to joining Hodgson Russ, Michael was an associate at a national law firm. Before attending law school, he was a bank officer and senior auditor with a major financial institution operating in upstate New York and northeastern Pennsylvania.

Honors
Former publications editor, Buffalo Law Review
Listed, Upstate New York Super Lawyers Rising Stars, 2016 - 2018

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Managing Director
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Shana is a licensed associate real estate broker and the managing director at CBRE|Buffalo with over 20 years of experience in the commercial real estate industry.

She is well-versed in the leasing, acquisition, and disposition of commercial properties - managing a wide range of real estate transactions in Western New York and across the U.S. Shana leads the CBRE|Buffalo office, building and maintaining long-term relationships by understanding client goals and objectives, and proactively responding with strategic solutions.

Shana supports CBRE|Buffalo's commitment to the industry and community through the support of organizations such as Cornerstone Manor, BISON Children's Scholarship Fund, 43North, WNY Women's Foundation, Child & Family Services, and Compass House.

Education
Licensed Associate Real Estate Broker
Buffalo State College

Client	Total Square Feet
BlueCross BlueShield of WNY	1,000,000
Ingram Micro	200,000
Rich Products	185,000
Visiting Nursing Association of	45,000
NY State Insurance Fund	40,000
Tower Group	36,000
ExamWorks, Inc.	26,000
Nixon Peabody	22,000
Prometic Life Sciences	20,000

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Partner, Real Estate Practice Area Leader, Real Estate Leasing Practice Leader, Retail Sector Industry Leader

Sujata is the leader of Hodgson Russ's Real Estate, Finance & Bankruptcy Practice Area. She draws upon her extensive experience in business and commercial real estate development, commercial leasing, and real estate investment and financing to provide business-focused legal advice to help her clients reach their goals. Her experience includes structuring acquisition and development projects for office, distribution, and manufacturing facilities; advising retail sector developers and operators in development, acquisition, leasing, financing, and 1031 exchange matters; and handling real estate financing matters, including nontraditional sale leaseback and ground-lease matters.

Highlights of Sujata's work include:

- Acting as lead real estate counsel to a publicly traded financial institution, a nonprofit health care organization, and a UK-based retailer with more than 200 retail locations throughout North America
- Advising companies entering into contracts with airport authorities, including structuring joint venture arrangements to qualify for minority- and women-owned business status
- Assisting in the development of hospitality projects, including management contracts, leases, franchise agreements, and joint venture agreements

Before attending law school, Sujata worked as a financial analyst for a Fortune 50 company, where her responsibilities included cost accounting, project analysis, budgeting, and forecasting.

At Hodgson Russ, Sujata previously served as a member of the firm's board of directors and is a former chair of its Committee for Attorney Recruitment, Development, and Diversity.

Notes Pages

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