Are Land Lease Buildings An Automatic Red Flag?

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A common presumption amongst real estate professionals is that land lease buildings are always problematic. A land lease building is usually limited to co-op apartment buildings and commercial buildings. It differs from a condominium building or a regular fee simple building in the sense that the actual owner of the building does not own the land on which the building is situated. Rather, the owner of the building leases the land from the landowner and then builds its own structure on the land subject to the terms of a land lease (also referred to as a ground lease).

The fear is always that once the land lease expires, the landlord can require the tenant to vacate the property and subsequently lose all ownership interest in the building, which they built on the land. The reason a condominium building can never enter into a land lease is that condominium units are considered real property and the owners acquire fee simple title, meaning they obtain absolute ownership, which cannot be revoked. On the other hand, a co-op apartment is not actual real property; rather it is shares in a corporation.

The key to properly analyzing the risk of purchasing in a land lease building is to understand the fundamental terms of a land lease. The two major terms which everyone must be aware of prior to buying in a land lease building are: 1) how is the rent calculated and how are rent increases calculated?; and 2) what is the term of the lease and how many years are remaining?

Rent calculations usually take place in one of three ways: 1) rent is based off of a fixed percentage of the fair market value ("FMV") of the land; 2) rent is fixed at a set sum subject to fixed increases, and 3) rent is based off of the consumer price index ("CPI"). The first formula is the most common one we see in co-ops in NYC. At the inception of the lease, the rent will be based off of usually 6-7% of the actual FMV of the land prior to the building being built. Then the rent will be recalculated every 10 to 30 years (depending on the terms of the lease) based upon the same percentage of the then FMV of the land. This helps the landlord hedge against any inflation risks. An appraiser is required to determine what the actual FMV of the land is. The risk for the tenant is a sharp increase in ground rent (which results in a sharp increase in maintenance) if the FMV increases significantly between recalculation periods. The second formula provides for a cap of the rent and provides a known sum as opposed to relying on an unknown such as future FMV. The last formula, CPI, is a risky one as it takes into consideration several factors unrelated to the subject property. CPI for a land lease is usually recalculated annually or every couple of years.

The majority of land leases are for 99-year terms. There may be renewal options at various points of the 99 years which are usually at the tenant's discretion due to perhaps to unknown in the rent calculations given the long duration of these leases. Theoretically, the value of the property declines the closer you get to the expiration of the land lease. One major item for us to be concerned with is if the lease has less than 30 years remaining on it. The reason being is that no bank will lend in a building with less than 30 years remaining as the term of the lease must be longer than the term of the mortgages being given (which are typically 30 years). Therefore, if you were to purchase in a building with less than 30 years remaining the transactions will have to be all-cash and your property value will likely decrease as you are limiting your pool of buyers. As most land leases were entered into in the 50s and 60s, we have yet to see one expire. If a land lease has 35 – 50 years remaining, then these risks are not as prevalent.

Most land leases which near expiration or come within the 30 year prior to expiration will end up in arbitration or litigation if the parties cannot agree to an extension. As we have yet to see a land lease for a co-op building mature, there is no precedent for what will happen if the parties cannot agree to an extension. However, it is difficult to imagine a court of law which would require hundreds of unit owners to vacate their units, lose all of their equity and have the banks which have liens on said units to lose their collateral. Thus, in my opinion, the initial fear of what happens when a land lease expires is not as important as understanding the lease. Typically, a land lease building has maintenance far higher than a non-land lease building, but the price per square foot is significantly lower in comparison. Thus, a land lease building can be a very attractive purchase for some people and a safe investment, should you really understand the terms of the lease.

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