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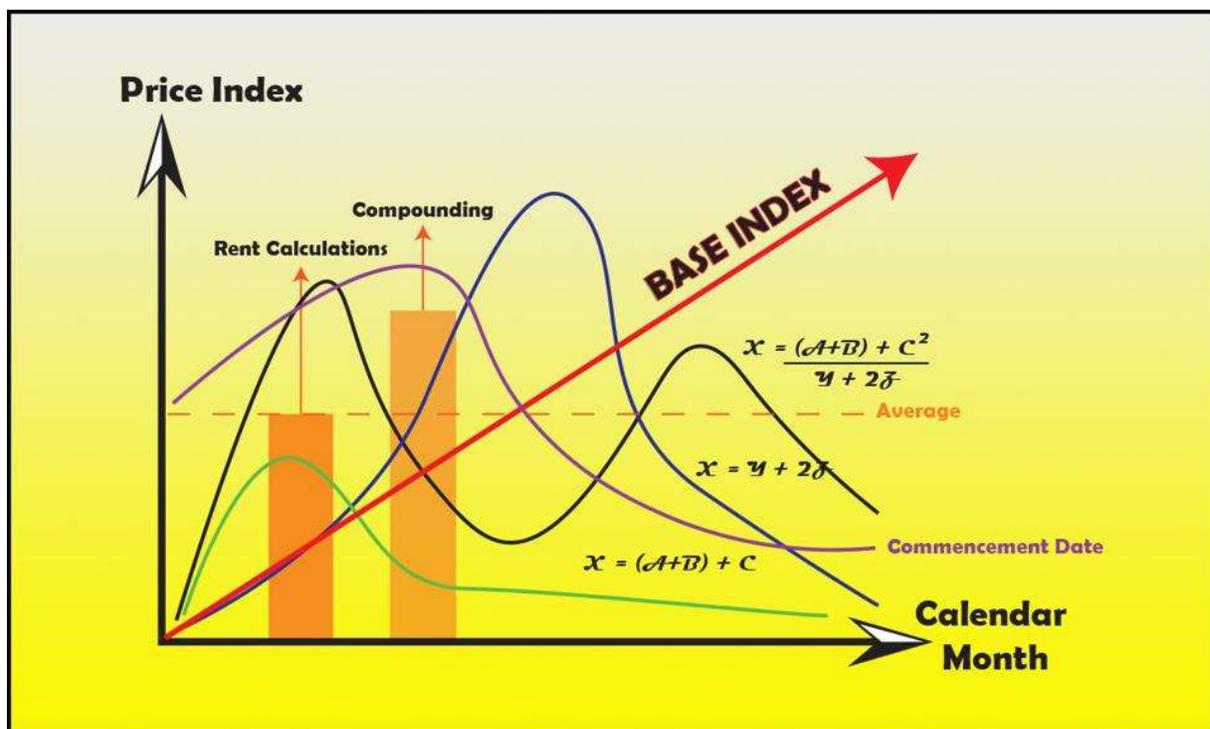
# How Two Words In A Ground Lease Destroyed Millions Of Dollars Of Value



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*I write about commercial real estate negotiations, deals and legal issues.*



A minor change in wording created an expensive error by confusing the ground rent adjustment formula. [-] RANJAN SAMARAKONE

It was a very common and typical deal provision: the rent under a 99-year ground lease would increase every year based on changes in the consumer price index (CPI) in that particular year, but the increase was always limited to a range of 2% to 5%. Each year the parties would look at how much the

CPI had risen in the preceding year. The rent would then go up accordingly, but always by at least 2% and never by more than 5%. This gave the property owner a reasonable hedge against inflation and protected the tenant from runaway rents.

Then the lawyers got involved. When the rent increase formula was translated into ground lease language, it resulted in a single sentence that continued for 16 lines, containing more than 200 words. That one sentence occupied about a third of a page. It had all kinds of clarifying phrases. It made the same points several times. It included seven separately lettered subclauses.

In calculating each year's consumer price index, the formula in the ground lease said to go look at the "Base Index" every year, and then measure how much the CPI had increased over the "Base Index." The "Base Index" certainly sounded like an appropriate starting point for the measurement. It was obviously the base from which each annual calculation would be made.

There was just one problem in the 16-line formula: the benign-sounding "Base Index" wasn't as benign as it sounded. The Base Index didn't actually mean the previous year's CPI. Instead, the definition of this benign-sounding term said the "Base Index" was actually the CPI in effect at the Commencement Date of the ground lease. That definition appeared in the ground lease 13 pages before the annual rent adjustment formula.

Because every year's CPI adjustment referred back to the CPI at the Commencement Date instead of the previous year's CPI, every year's CPI increase started out by measuring the entire increase in the CPI since the ground lease was signed. The rent would then go up, each year, by that entire increase, but subject to an annual cap of 5%. Net effect after the first couple of years: instead of rising within a band of 2% to 5% every year depending on each year's CPI increase, as the business deal contemplated, the rent would rise by 5% every year, pretty much no matter what.

The landlord refused to change the reference to the Base Index and insisted on applying the ground lease in accordance with its terms. So the landlord claimed it was entitled to, in effect, an automatic 5% rent increase every year, even if the CPI didn't go up at all in the previous year. This would continue for the remaining term of the 99-year ground lease.

The tenant estimated that the use of the commencement date Base Index – rather than a Base Index referring to the previous year's CPI – destroyed tens of millions of dollars of value in the tenant's leasehold position.

A problem like this could happen to anyone in any complex legal document. “Base Index” didn't remind the reader what the phrase actually meant. Any

correct-sounding general phrase used in a legal document doesn't necessarily mean what it sounds like it means. It might well mean something else. A simple concept might be expressed in so many words that it becomes impossible to understand. Readers have to keep so many words in mind that they miss a fundamental error.

In this ground lease, whoever wrote the 16-line rent adjustment paragraph obviously wanted to confirm and clarify many important details about the adjustment formula. But the writer failed to confirm and clarify the one thing that mattered most. And no one reviewing any draft of the document for the tenant ever picked up on the anomaly.



**Joshua Stein**

I help buyers, sellers, borrowers, lenders, tenants, property owners, and other commercial real estate market participants identify and achieve their business goals. To do that, I need to understand risk, security, numbers, value, financeability, flexibility, and exit strategy. Some legal issues matter a lot and many don't. It's important to know the difference. I write extensively on commercial real estate law and practice – over 300 articles and five books on leasing, lending, and other areas, with some emphasis on ground leases. I occasionally serve as an arbitrator or expert witness in complex real estate disputes. That lets me see how transactions go wrong. Often, the problems could have been avoided by keeping it simple and following the money, but everyone got sidetracked. As a Forbes contributor, I try to tell stories that teach worthwhile lessons for real estate deals. **Read Less**

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