

Public Body Leases and Valuations

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INTRODUCTION

Quote from the editorial note from the judgement of Justice Roper and Ralph Frizzell in the case of Associated Taverns Ltd and the Commissioner of Crown Lands in June 1983 relating to the values for freeholding.

“We consider that a lease under the Land Act is essentially an agreement between two parties to carry on a business, of which the Crown, in this case, provides the land (for which it receives a rent) and the company provides the Capital (for which it receives the income less the rent).

The Crown receives a fixed term rental of 4.5% on its resources and the company receives the remaining income on its resources.

Inequality would result where the value of either party’s resources produced an unduly large or small share of the total income available, now and in the foreseeable future.

To this extent the land resources should be utilised freely by the investment of appropriate improvements to achieve this. The lessee should not be expected to pay a rental based on unexploitable short term potential use of the land, and conversely the lessor should not be expected to forgo his fair share of the income from the land and provide a return on inappropriate development to the lessee. The lessor further should not be expected to forgo income because of the inferior management skills of a lessee.”

For Rural leases are we now looking at the carrying capacity of the land exclusive of improvements, the present developed carrying capacity – apportioning the calculated returns accordingly – then capitalising the Crown and lessee’s share at their appropriate rates.

This proposal appears to suggest a specialised form of productive valuation and would be extremely sensitive to:-

*Farm cost structure,
Price variation and
The fixing of capitalisation rates.*

This is an interesting and informative case highlighting the problems associated with the LEI assessments. The emphasis appears to move to a fair balancing between the lessee and lessor, and the provision for an equitable rental.”

A lease creates two land estates from one freehold estate, each estate is held by different people, one referred to as the lessor the other the lessee. In a freehold estate the possession rights are held for an indefinite time and include the rights of sale and rights to pass on to heirs.

The essential element of any lease is the specification of the time of possession of the land for the lessee.

In any lease there are two parties involved, and two items - land and rent.

Person who grants possession	Landlord/Lessor	(who receives rent)
Person who receives possession	Tenant/Lessee	(who pays the rent)

Definition of a lease

- to grant possession of property to another for rent for a specified time.
- a contract of possession of property for a specified time.

A lease is in effect the "sale" of some of the rights to land in exchange for periodic rent for a specified time.

- Elements
- land possession
 - rental payments
 - a termination date

One of the great advantages of leases is there is almost infinite scope to vary the terms and conditions. A lease can be tailored for almost any situation, to achieve any ends, the 999 leases in perpetuity and cross lease titles are two examples of the flexibility of the lease as form of tenure.

This paper concentrates on long term leases with perpetual rights of renewal - leases where the parties have long term commitments to the lease and have infrequent opportunities to withdraw from the contract. Leases where the lessee does not have the right to freehold. Leases where the lessor is committed to remain the lessor in the foreseeable future. These are the leases which from time to time, over history have proved to generate the most problems and the bitterest of disputes..

These are the ultimate in long term leases and often referred to as ground leases or "Glasgow leases". They have the characteristics of:-

- Perpetual rights of renewal
- Lease of the land only excluding improvements
- Lessee establishes and maintains the improvements

Long term arrangements with long periods of fixed rents, often with substantial rent savings accruing to the lessee creating "goodwill" value. The lessor usually provides for compensation for the improvements if the lessee surrenders the lease.

Low risk, stable, easy administered investment of moderate return for the lessor

Examples of these leases are Public Bodies Leases Act leases (sec 7d -h and sec 11b), Crown renewable leases, Pastoral leases, Maori Reserved Land Act leases and Maori Vested Land Act leases.

The popularity of these sorts of leases has been declining in recent decades – that is for those who have the option to sell or freehold. Expertise in the management and administration of long term leases is also declining with less administrators, lawyers, valuers experienced in ground lease management. Add to this a lack of understanding by lessee's and lessor's of what they contribute to the lease and what returns they can expect from the leasing agreement.

This decline in popularity has been driven by dissatisfaction, especially on the part of lessor's as to their returns in the form of rent from their investment. In recent decades we have seen many changes to ground leases eg Free holding of LIP's, Land Act Amendments of 1970, Pastoral lease restructuring and MLRA 1997 amendments. Yet despite all these legislative changes, disputes between lessor's and lessee's is still of great concern with the costs of these disputes adding to the dissatisfaction.

Quote from a publication by Leone Freeman 1993 “ *this form of tenure is a common, but poorly understood form of land ownership in New Zealand, and the review of these ground rentals is an extremely contentious area. This is evidenced somewhat by the number of property arbitrations centered on this fact – far more than any other form of property dispute*” .

In a ground lease what are the contributions of the parties and what is the nature of their relationship?. To answer that an understanding of the contribution by the lessor to the lease and hence a description of the terms Land Exclusive of Improvements (LEI) and Unimproved value (UV) are required.

The land is essentially the lessors contribution to the lease.

Land Exclusive of Improvements is referred to in the PBLA and the Land Act but no definition is provided in either act. Maori land acts refer to the Unimproved Value which does have a definition in the old Valuation of Land Acts. In essence the UV definition is the value of the current market state with the clause “as if no improvements had been made” added onto the end. This is not a difficult task when the improvements are structural improvements and can be readily identified. It is much more difficult when the improvements are development and can not be seen or identified by inspection. This is a common problem, especially on rural land where they are often referred to as the “invisible” improvements. The problems in identifying the development improvements and the large amount of disputes which occurred was the reason why those definitions were removed from most legislation, except they remain in all ground leases.

For most properties there is little difference between the two terms. What they do have in common is they are not well understood by both lay people and professionals. The LEI (or UV) is however the major component of the lessor’s contribution to the lease. A lack of understanding of the lessor’s contribution is likely to be the cause of many of the disputes over rentals and dissatisfaction with leases.

The LEI and UV are comprised of the basic land resources of the property:

- The land area
- The location (situation, amenities, services, RMA, zoning, infrastructure)
- The soils
- The climate
- The physical characteristics (elevation, contour, aspect)

These are all viewed in a state excluding the improvements. (or “as if the improvements had not been made” in the case of UV)

The most important dimension to the definitions is that of time. Excluding the improvements is not a process of going back in time to a point where no improvements had been made. That would fix the basic resources in an historic time warp where there would be little demand (a smaller, less wealthy and less knowledgeable population) to develop the land beyond its original cover. (whatever and whenever that original cover was !)

These states of land described as LEI and UV are contemporary in time; to determine them is a process of envisaging the basic resources in a modern context with all of the current technology, building technology, animal breeds, plant cultivars, human populations, and infrastructure. The most important aspect of the lessor’s contribution to the lease is what the land can be, not what the land was. What it was in history is largely irrelevant.

Quote of Murray Mander in Robertson case 1958. *“In arriving at the unimproved value I have imagined Mr Robertson’s property alone to be in its unimproved state with the remainder of the countryside in its present state”*

This component of the lessor’s contribution is referred to as potential or land use capacity. It is in essence the combination of the basic land resources into a platform for the lessee to develop and grow their business on the lease land. To do this the lessee must make the decisions and provide the capital to effect the improvements, and operate the business.

Land use capacity is defined as any use of land which shows a surplus of returns over the costs of utilisation. In simple terms - any use that shows a profit. Some land by virtue of its resources has many land

use capacities, some land has only a few or only one, and some has none; we call land with none “barren and waste”. While land may have a variety of uses which will show a profit, there is only one use that will show the greatest profit or surplus over the costs of utilisation. That use is known as the highest and best use.

This concept of highest and best use is the basis of most decisions that are made about the use and value of land, yet it is complex, multi-dimensional and often not well understood in our community.

In respect of leases the highest and best use is the use of the land in the lease which provides the most benefit to both the lessee and the lessor. If the land in a lease is used at the highest and best use then we maximise the mutual benefit to both parties. It is the continuation of this mutual benefit, to the parties to the lease, that ensures the long term survival of the lease arrangement.

Note that the lessee, in the running of the business, has the responsibility of recognising the highest and best use, providing the capital and management to implement the use and has the ongoing responsibility to maintain the highest and best use. (change the use and the mix of improvements if the highest and best use should change – the risk of the investment in the improvements is taken by the lessee). The lessor enhances the investment environment for the lessee by including in the lease clauses such as:-

- the right of sale of the lessee’s interest
- compensation for improvements effected or purchased by the lessee in the event of termination
- the right for the lessee to have the rental assessed excluding the improvements.

The lessor provides the platform for the lessee to do that but has no control over the business and hence the use of the land. The lessor is entitled to receive a rental based on the highest and best use of the land even if the lessee chooses to operate the land at something less than the highest and best use. Also if the lessee is able to make profits over and above the highest and best use through special skills applied to the business then the lessor is still only entitled to the rental based on the highest and best use.

The rental is the amount of rental that is based on the lessor’s contribution to the lease. Many of the disputes over rentals stem from the misunderstanding of what the lessor (and the lessee) contribute to the lease, especially on the part of the lessee.

"Rent" the amount lessee pays periodically for the land possession rights received.
the amount lessor receives in return for granting the possession rights.

In long term leases the concept of “market rents” is difficult to apply using the comparable market rental methodology. Once the lease begins, there is no continuing option for either party to test the market by terminating and moving on, as there is in a residential tenancy. Both parties to a ground lease have made long term commitments and investments in the lease and are to a large extent “captured” by the lease.

There are very few new leases where the parties freely enter into a lease agreement to provide indications and comparisons as to the level of market rents. Very few existing ground leases have options where the lease renewal requires public competition through the calling of tenders or at auction for the renewal of the rent.

The most common method for setting the rents at the reviews is the rental rate method. This involves a multistage process, the first of which is to assess a market value of the LEI or UV (the lessors contribution to the lease), the second to determine a rental rate (% of LEI), and the third stage is to apply(modify) the rental rate or value to the specific property and type of lease. Every one of these three stages is fraught with problems. There is virtually no land still in its LEI or UV state (ie without any improvements). There is even less chance of land in this state actually selling on the market to provides comparable sales to assist in determining a vale. Assessing the market value becomes a matter of opinion rather than a statement of fact with limited or no sales evidence to support that value.

Quote from the Associated Taverns case *“We recognise [that] the problems of obtaining comparable sales of land in the undeveloped state...”. “In our opinion therefore the first proviso require the valuer to be sure that the division of values when they are made where there is little or no direct sales evidence shall be carefully weighed to provide a fair balancing of values between the lessor and lessee.”*

There is no clean market evidence as to the rental rate as almost all computed rental rates are influenced by the specific circumstances of the lessee and lessor in the lease. Even worse they may also be contaminated by the relative bargaining strengths of agents, valuers or arbitrators that have become parties to a rental dispute.

Lastly there is no clear way to modify a rental for a specific property or specific lease clause. Limitations in the lease which prevent the lessee attaining the highest and best use, will have an impact on both the rental, and the improvements which are effected by the lessee. The other issue often confronted in this third phase is the value associated with the subdivisional potential of the land. A lessee cannot exploit this component in a business operation. A sub lease may be possible but not practical. (Note the Associated Taverns dispute over LEI values for free holding quoted at the beginning of this paper was about subdivisional potential – the value of surplus land in a lease situated in the Bishopdale shopping centre in Christchurch)

In summary there are problems in the complexity of the LEI and UV. There is also the misunderstanding of what is the lessors contribution to the lease and how that contributes to the lessee’s business. There is then the problems of determining the rental which should be based on the lessor ‘s contribution. This combination of factors and the lack of clarity and uncertainty could be described as fertile ground for continuous conflicts or disputes.

The traditional approach to the setting of the rents for ground leases is therefore at the route of the problem. The value of the LEI (or UV) with a % rental rate is no longer the only or appropriate method to determine the rent. This method is failing as evidenced by the steady decline in ground leases in recent decades, the high incidence of arbitrations and court disputes, and the now widespread dissatisfaction with ground leases by both lessors and lessees. The current system also breeds advocacy further exacerbating the problem. The current approach leads to too much time and money being spent on advocating their own situation without reference to the other party to the lease.

The solution is to move towards more recognition of the partnership in the land between the lessee and the lessor. Create a situation where the parties to the lease are working with each other for common goals, recognising the others input and situation and more directly managing the lease so that both parties, over the long term, continue to gain benefit from the leasing arrangement.

To achieve this, the key is for both parties to be satisfied with the amount of rent. The rent, after all, is the main mechanism which can be altered from time to time to maintain the flow of benefits to the parties to the lease arrangement. The rent setting need not only be based on the value of the LEI but should also be based around the business being undertaken on the land. That would involve a much more detailed economic analysis of the business and a process allocating the benefits from that business fairly. Ideally this would need to be done by a person who is truly independent and who possesses the skills to do such an economic analysis.

There are only 4 ways to set any rental:-
Market comparison
Annual % of value of lessor’s contribution
Profit share
Mutual agreement

The first two of these has proven to be inadequate – that leaves only the last two.

Note that the Public Bodies Leases Act 1969 does not specify the method which must be used to determine the rent nor does it refer to a % of the LEI or the term market rent. It simply refers to “fair annual rent” as the basis of the rental.

For all its faults one great advantage that a lease has is that you can virtually do anything you like as long as it is by mutual agreement.

Actions a lessor can take to maintain their interest in the lease:-

1. Maintain good records, current lease copy, log lessee contacts
2. Perform administration on time, diary of obligations, bring up files eg 9-3 months
3. Visit the lessee periodically remind the lessee of your interest in the land, of them and their business.
4. Observe land use, observe covenants are complied with, record with photographs of property imps.
5. Make a point of calling on lessee in the 2 years prior to any rent review - it is a partnership - treat it like one
6. Maintain good relations with lessee, cordial, formal, yet make them aware of your interest. Hire
7. Independent experts when problems arise - negotiate - there is always lots of scope for negotiation.
8. Periodically assess the clauses in the lease and redraft where necessary at renewal – especially where the clauses may prevent the lessee achieving the highest and best use.

The lessor needs to be more interested in the business which the lessee operates on the lease; it is that business that is the source of the funds which pays the lessor their rent.

Recognize that the long term survival of a lease is to maintain equity to both parties. - if both parties do not continue to derive benefit from the lease then in time that lease will fail or the parties to it will change.

A ground lease is a partnership in the land and like all partnerships there is only one scenario that ensures survival “win - win” any other combination that involves the word lose will ultimately become “lose lose”.

Advocacy will inevitably result in disputes (which are invariably expensive) Try and keep differences out of the hands of advocates, at least initially. The most powerful advocate to advance your interests in a lease dispute may not necessarily ensure long term success.

The best professional advice is that which is taken before the dispute arises, not during or afterwards.

If long term ground leases are going to survive, and the current trend of declining numbers is that they will not, then we have to change the way in which we set rents. The long term survival of the lease is dependant on one simple concept, both parties to it must continue to derive a benefit from the leasing agreement. It is a form of partnership and to survive needs to be treated like one.

As a party to a long term lease, fighting over how big your portion of the pie will be, is not as productive as putting your efforts into growing the size of the pie. Growing the size of the pie is often easier if its done by co operation the other party to the lease.

References

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