Topic 9: Leases

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This material deals with the *non-freehold*, or *leasehold*, estates (possessory but exist for a specific period of time, whereas freehold estates exist for an indefinite period). There are two parties whose interests concern us:

- The *Lessor* (landlord) – who holds a *leased fee* estate (has value based on lessor's ability to collect rents)
- The *Lessee* (tenant) – who holds a *leasehold* estate (has value if rents are negotiated at a below-market level, especially if the lessee is allowed to assign rights under the lease to another party)

The market value of the leased fee interest plus the market value of the leasehold interest generally should equal what the market value of the fee simple interest would be if the land were unencumbered by the lease. (See numerical examples in section I at the end of this outline.)

Under a *lease*, the lessor gives up the rights of use and exclusion in return for consideration: rent payments. (In at least two 2022 and 2023 situations, people moved into Chicago houses that were vacant after the previous owners' deaths, while the deceased parties' heirs were trying to sell the properties. The "squatters" knew that if they claimed to have leases, even if they could not produce copies of the leases or identify their lessors, they would not simply be removed by the sheriff's office as trespassers. Both were able to remain on the premises – had changed the locks – while the rightful owners had to pursue their claims though the court system. The true owners were still required to pay property taxes, even utilities, while the legal wheels turned over many months.)

A lease is a binding contract. If it is originally scheduled to run for more than one year, it must be in writing in accordance with the statute of frauds to be enforceable in court (most one-year residential leases for houses or apartments are put in writing anyway).

A. Types of Leasehold Estates
(They differ by length of time period, rights of the parties, and manner of termination)

1. *Estate for Years* (or estate for a stated term) – it need not actually be for multiple years; it could be for 1 day or 99 years or any other period. The key identifier is whether the termination date is known on the day the lease is signed. A commercial real estate lease might have an initial term of 10 years, with an option for the lessee to renew for some number of five-year periods (an office lease might initially run for 15 years, a retail lease for five years – but leases can run for any period: in 2009 CVS leased the ground floor of a San Francisco building for 45 years, and in 1759 Irish brewer Guinness signed a 9,000 year lease on a Dublin brewery building, at a rent that is amazingly low at this point). Long-term leases often are recorded, as are assignments of rights under a lease, just like deeds and mortgages are. (One legal reference mentioned the interesting counter-example of a commercial lease with a provision that the lessee could *not* record it without terminating the lease; the intent may have been to protect confidentiality for the lessor.)

In fact, a long-term lessee may be viewed for some legal purposes as the leased property's owner; a California court ruled in 2020 that when the CVS building was sold while more than 35 years remained on the lease, under state law the transfer of the landlord's reversionary interest did not constitute a sale that would cause value to be reassessed or a transfer tax to be paid.[1] The estate for years has fixed starting and ending dates. It may terminate at a date other than the stated ending date, either by agreement or by merger of the two estates (you do not have to pay rent to yourself). But a sale of the property, or even the death of the lessor or lessee, generally does not terminate a lease (*e.g.*, the lessor's estate becomes the new landlord and the lessee's estate assumes the obligation to pay rent).

(Unfortunately, a lender's foreclosure on the landlord's loan may terminate a lessee's rights, particularly if the lease was signed after the loan was in place. In the recent financial turmoil, there were some commercial property lessees that were forced to move when their landlords defaulted on loans and the lenders exercised their rights to terminate existing leases – but a lender that forecloses typically would want to keep lessees in place and paying rent, as long as the rents those lessees are paying are at current market levels. A lessee subject to this danger of eviction must be careful about paying rent in advance.)

2. *Estate from Year to Year* (or estate from period to period) – there is no stated ending date, so the party who wants to end the relationship must give reasonable notice to the other party of the intention to terminate (likely a month if rent is paid monthly). This type estate may be created by an explicit period-to-period agreement or by implication; if a lessee pays rent every month and the lessor accepts it, a court would likely rule that an implied month-to-month

lease exists (an example might be a holdover tenant situation; the landlord continues to cash monthly checks that the tenant tenders after an initial formal lease expires). An oral lease for a period exceeding one year is not enforceable in court (violates the statute of frauds), but if rent is paid monthly it would likely be interpreted as an implied estate from month to month. Again, the death of a party typically does not terminate the agreement.

3. *Estate at Will* – much like an estate from period-to-period. In theory, there is no need for notice prior to termination. In practice, state laws usually require some type of termination notice, typically 30 days. If the lease does not explicitly specify an estate at will, a court would be likely to interpret it as an implied estate from month to month. In this situation, the death of a party generally terminates the estate.

4. *Estate by Sufferance* – exists when a party whose lease has expired (or a borrower who has been foreclosed on) remains in the property against the owner's wishes. If the lessee did not have some legal designation the lessor would not be able to continue charging rent. In Illinois, the lessor can *charge double rent*. (A lessor can not just move out the lessee's possessions while the lessee is away – though someone renting a room in the landlord's home has less protection than a lessee; an owner evicting a *roomer* may be able to remove the roomer's possessions.)

B. Characteristics of a Lease (a form of contract)
1. *Requirements of all contracts* – offer and acceptance, consideration, competent parties, legal purpose.
2. As a type of real estate contract, a lease should contain a *precise legal description of the leased property.*
3. *The term should be specified*, with all significant dates (*e.g.,* start and end) noted.
4. Must *be in writing if for longer than 1 year*; but putting things in writing is a good idea even for a shorter term.
5. *Signature of the lessor* (just like a grantor must sign a deed while a grantee need not); but it is good for the lessee to sign also, to show that the lease features are understood and acceptable. Multiple lessees of the same property (*e.g*., roommates) can have multiple leases or just one joint lease. But under a joint lease, each lessee can be held fully responsible for the total rent if the others do not pay. (It is called being *jointly and severally liable*.)

C. Rights and Responsibilities
A lease gives rights to, and places responsibilities on, both the lessor and the lessee. The lease may contain explicit *covenants* spelling these out, but if specific provisions are not spelled out, then state law applies. Examples:

1. Possession – the law views the lessee as having broad rights of use and exclusion (even being able to exclude the lessor), so leases usually specify the lessor's right to enter for inspections and other reasons (but it must be at reasonable times and for specified purposes, such as making repairs – one legal source states that a lessor can not even allow the police in to search the property, because once a valid lease is in place the rights to use and exclusion are held by the lessee). If the landlord decides to sell a property that is occupied by a lessee, local laws (*e.g*., in Washington, D.C.) may give the tenant a *right of first refusal* (the power to preempt other buyers and purchase the premises at a price equal to the highest offer the seller has received from a legitimate offeror). A lessee that does not pay rent on time or violates other lease terms is subject to being *evicted*. Strict laws apply to the eviction process (the lessee is entitled to due process), but ultimately a lessee in violation of lease terms will be required to vacate, and in an extreme case that lessee may be physically removed by county sheriff's deputies. One source states that the eviction process, from initial hearing to a final judgment, can take up to six months.

[During the Covid-19 crisis the federal Centers for Disease Control enforced a moratorium on evicting lessees from residential property on public health grounds: concerns that displaced tenants would end up homeless, or would move in with relatives and the crowding would spread the virus. A Federal Reserve study found that approximately two million U.S. households were unable to pay rent because of Covid-related problems, and U.S. Census Bureau figures showed 13% of renters in Illinois unable to pay. (Legal experts continue to debate whether the CDC has the legal authority to prevent landlords from evicting non-paying tenants.) An initial program and extensions ran for more than a year, ultimately ending on October 3, 2021. Illinois had a renter protection plan even more extensive than the federal plan, but it also ended on 10/03/21. The plans' intent was to help those who could not pay rent due to illness or loss of income caused by Covid. Congress allocated almost $50 billion in assistance to be distributed to tenants or their landlords through state and local governments and private organizations, but by the time the eviction moratorium ended only about 11% of the money had been distributed (Illinois was actually #2 among the states in delivering federal aid, and it had a separate state assistance program as well). Critics said paperwork burdens were among reasons for delays in getting aid to needy tenants and struggling landlords. The inability to evict tenants who were generating no revenue caused major problems for landlords, of course, even though tenants were not legally relieved of the obligation to eventually make missed rent payments – especially since landlords' operating costs, including the need to pay property taxes or lose their buildings, still had to be met, and landlords asserted that aid

tenants received rarely reached landlords anyway. State and local laws passed in late 2021 to provide attorneys for tenants facing eviction were criticized for wasting resources that could have been used for direct rental assistance.]

2. *Any legal use is permissible* by the law's implication if the lease contains no specific provision to the contrary. But lessors commonly prohibit certain uses (*e.g*., no business run from your apartment unit even if zoning laws would permit it). *Lessees sometimes can prohibit certain lessor actions* as well (*e.g*., in a shopping center, the lease might have a provision preventing the lessor from renting to a business that would directly compete with the lessee).

3. By common law, rent is due at the end of the stated term, so *most leases specifically call for payment in advance*. The amount should be specified; most long-term leases call for the periodic *escalation* of rent to offset inflation. The landlord has the right to timely rent payment; if a lessee pays late the landlord should issue a written warning against further late payments (and enforce it) or the lessee may gain the right to continue paying late. While rent payment by check or cash generally is acceptable, a 2023 amendment to the Illinois Landlord and Tenant Act prohibits lessors of residential real estate from requiring lessees to pay rents through electronic funds transfers.[2]

4. Repairs and constructive eviction – as a practical matter, lessors who are responsible for repairs usually want to make needed repairs to prevent added damage, and to make sure that the work is done correctly. (In a commercial lease, it is not unusual for the lessee to be responsible for all inside repairs and the lessor to be responsible for exterior repairs and maintenance.) Most states have laws stating that leased residential property must be *fit for habitation* and kept in reasonable repair – an "implied warranty of habitability;" lack of running water or adequate heat would be clear violations. In some cases if a lessee has notified the landlord of a serious problem affecting habitability and, after a reasonable time, the landlord has not made needed repairs, the lessee can withhold rent by paying it to a third party escrow until repairs are completed, pay for the repairs and deduct the cost from subsequent rent ("repair and deduct"), or pay for the repairs and sue the landlord to recover the costs. A family paid their rent to a law firm for several months after mud from construction outside their upscale apartment's patio impeded their use of the parking lot and advertised outdoor amenities; a court held that the implied habitability warranty had been breached, and reduced the rent 15% monthly for the project's duration.[3]

[A landlord can legally evict a residential tenant, meaning require the tenant to move out, if the tenant fails to pay rent or in most cases if the tenant does damage to the property or causes problems for other tenants. But a landlord's attempt to evict a tenant for complaining about the property's condition, or for reporting the landlord's behavior to housing inspectors or other government officials, is prohibited under the Illinois Retaliatory Eviction Act (and similar laws in other states). Some local areas have special courts for handling landlord/tenant issues.]

Generally a lessee who simply chooses to vacate ("surrender") during the term of a lease owes rent for the remaining term (most state laws require landlords to mitigate damages through good-faith efforts to find replacement tenants), while if a lessor evicts a lessee the lessee is no longer required to pay rent. If needed repairs or other problems, such as safety issues, leave a residence uninhabitable, a lessee can reverse the process and claim to have been, in effect ("constructively"), evicted and thus no longer required to pay rent. (Lessor may be accused of having "substantially interfered" with the lessee's use of the rented property.) To successfully assert *constructive eviction* a lessee must first notify the lessor of problems that need to be addressed, and give the lessor reasonable time to address them. Lessee then must vacate the premises; you can not claim constructive eviction and stop paying rent, yet stay on site.

A New York landlord sued for remaining rent owed when a couple moved out of their apartment halfway through their one-year lease period. The couple, who had three small daughters, claimed constructive eviction because a high-risk sex offender had moved into an adjoining unit, and the landlord did not respond to their request to terminate their lease. The court did not rule that there was constructive eviction *per se*, but rather noted that the pre-printed lease form explicitly assured "quiet enjoyment" of the premises, that quiet enjoyment logically included safety, that conditions made it unsafe for this couple to remain, and that it was unconscionable for the landlord not to agree to their request. Among points raised by the judge were that lessors must protect lessees from foreseeable dangers, and that state law allowed domestic violence victims under orders of protection to vacate their leases so they could move away.

(The term constructive eviction also is used to describe the status of a real estate owner who is found not to have received good and marketable title, or other rights, at the closing. In one case an owner who was found not to have received mineral rights in the conveyance was judged to have been "constructively evicted," even though he still had possession of the land, and not getting the mineral rights provided grounds to sue the grantor for damages.)

Historically under property law a lease was primarily for the use of land, often to grow crops. Structures were seen as incidental to the land; thus lessees generally were expected to pay rent even when improvements were destroyed, for example by fire. In more modern times, when many leases have been more focused on residential or other uses of buildings, legislative bodies and courts have created protections like quiet enjoyment and the implied warranty of habitability.

5. Improvements – the law expects the lessee to return the premises to the lessor in their original condition (with ordinary wear and tear excepted), unless the lease specifies otherwise. Permanent improvements made by the lessee tend to be viewed as *fixtures* that must stay with the property unless they are *trade fixtures* (business assets like machines or show cases that are firmly attached for use but are expected to be taken away when a commercial lessee vacates). (A late 2022 news article discussed how multi-year "nester" residential lessees use tools like temporary wallpaper to customize their surroundings without permanently changing the property.)[4]

6. Waste – the lessee can not abuse (voluntary waste) or neglect (permissive waste) the property in a way that reduces its value (except through normal wear and tear, which at least one source says includes nail holes from hanging pictures but not large holes, or stains), or even undertake steps designed to increase the property's value (ameliorative waste) without the lessor's express approval. An improvement approved by the landlord that is classified upon installation as a fixture should remain with the property, not be removed, when the lease expires.

7. Property Taxes – revenues received must be enough to cover all costs for any business to remain viable over the long run, so lessees ultimately provide the money for lessors to pay *ad valorem* property taxes. A lessor of residential property, who can monitor changing costs and build them in when setting new rents each year, almost always includes the expected cost of property taxes in the rents charged. But the lessor of commercial real estate with a long-term lease is more likely to require the tenant to pay the property tax as a separate obligation rather than building the expected cost into the rents charged. That way the lessor does not have to predict how tax assessments may change over a long lease period; the lessee simply reimburses the lessor for taxes paid as those changes occur – or if the lessee directly wrote a check for the taxes to the county, the lessor would want to confirm that they had been paid. (One source shows property tax as the highest cost of owning income-producing real estate.)

8. Security deposit – a dollar amount, often equal to two months of rent, paid at the beginning of the lease period to the lessor to cover the cost of damage a lessee might do to the leased property, or to cover rent that the lessee might fail to pay before moving out. The law implies that there be no security deposit and that, in larger properties, if one is required the lessor should pay interest. In practice, leases usually stipulate that there will be a security deposit, and that the lessor will not pay interest on it. Tenant advocates have complained that the need to pay security or "damage" deposits can place hardships on low-income residential lessees. A New York state law enacted in early 2020 caps security deposits at one month of rent, and Cincinnati passed a city ordinance at about the same time allowing renters to pay monthly fees or buy security insurance coverage instead of paying lump-sum deposits upon signing leases. A company that sells insurance covering a lessee's personal property might also provide security deposit coverage, for a one-time initial premium or smaller monthly premiums. Landlords express concerns that they will have to battle insurance companies to collect on claims instead of tapping lessee' deposits already under their control; security deposit insurance may be too new at this point for us to know how well it will work.

Some recent residential rental transactions have seen landlords move beyond requiring security or damage deposits to requiring a younger tenant's parent or other third party to co-sign or guarantee the lease. The guarantor may have to provide income tax returns or other confidential information. A "prop-tech" firm called Rhino provides renter's insurance, damage deposit insurance, and guarantor service (the guarantor fee might equal a month's rent).

[Illinois law places no limit on the size of a landlord's required security deposit. But it does require owners of larger complexes to pay interest on deposits held six months or more, and requires owners of at least five rental units to return deposits in full within 45 days of a tenant moving out if no rent is owed and the unit is clean and undamaged.]

9. Options – a lease might contain one or more of these options:

   a. *Renewal* – this option gives the lessee the right to renew the lease under pre-determined terms.

   b. *Purchase* – the lease may provide for some portion of the past rent to be applied to the purchase price, but this outcome is not typical. The purchase price must be specified, or this option has no meaning or value (everyone always has the right to negotiate a price later). A tenant had an option to buy 400 rented acres for $40,000 any time during a five-year lease. When he sought to exercise the option the lessor refused to sell unless rent was paid for the lease period's remaining sixteen months. A state supreme court ruled that

a lease merges into ownership when an option to buy is exercised, so no rent was owed unless the contract specifically required such payment.[5] (Interpreting the option provision the way the selling lessor wanted the court to interpret it would not make economic sense. If the option was exercised and the exercise price was a good reflection of the land's market value, the selling lessor would be able to buy new land with the sales proceeds and rent it out while also collecting rent on the land sold, double-dipping on income – an outcome an informed tenant would not be expected to agree to when negotiating the lease.)

c. *First refusal* – a provision of this type would allow the lessee the first right to buy the property if the lessor decides to sell it; no price is specified, so the lessee/buyer must match the best offer the lessor/seller has received from another legitimate bidder. A similar type of option would give the lessee the right to expand into adjacent space that another lessee vacates.

D. Rent Provisions

One of these arrangements (or a variation thereof) usually applies:

1. Gross lease – the lessee pays a fixed rent, and the lessor pays all expenses of operating and maintaining the improvements. This type of lease might be seen with residential property, primarily some apartments, but would not be common with commercial property. It might be called "modified gross" if the lessee pays targeted operating costs separately from a base rent, perhaps utilities in a residential lease or amounts in excess of a "stop" that limits the lessor's more general operating cost obligations in an income property lease.

2. Net lease – the term "net" means that the lessee, usually of a commercial property, pays separately for at least some things that the lessor would simply build into the rent charged under a gross lease, with the lessee's base rent progressively lower in a competitive market as it pays separately for more of the costs that apply to the property. A lessor can not predict what certain items will cost several years down the road, particularly items whose costs are entirely beyond the lessor's control. So it would tend to be more efficient in a long-term lease arrangement for the lessor to have the lessee provide the money for paying after these types of costs are known – because in a competitive market for products and services the business tenant will pass all of those costs along to its own customers as they are incurred. There is no definite meaning of "net" in this context, though frequently we see the terms:
   - "Single net" lease if the lessee pays a basic rent and pays separately for local property taxes (its proportional share of the taxes in a multi-tenant property), while the lessor includes expected costs of repairs/maintenance of structural components and the exterior of the building, and of replacing mechanical system components – which the lessor would tend to have some control over – into the base rent charged.
   - "Double net" lease if the lessee pays basic rent and then separately provides the money to pay for property taxes and property/casualty insurance premiums (proportional shares in a multi-tenant property), with the expected costs of all building operations/maintenance/replacements built into the base rent.
   - "Triple net" lease if the lessee pays a basic rent and then provides separately for the payment of local property taxes and property/casualty insurance, and is responsible for most operating/maintenance costs of building *interior* areas; the landlord handles repairs/maintenance of structural components and the *exterior* of the building, and of replacing mechanical system components, incorporating the expected costs of those items into the base rent charged.
   - "Absolute triple net" or "bond" lease if the lessee pays basic rent and then pays the lessor separate amounts to cover local property taxes and property/casualty insurance, and is responsible for all costs of operating and maintaining building interior, exterior, structural features, and the site, and even replacing mechanical system components as they wear out. (The lessee under a multi-year commercial lease is sometimes said to be, in effect, the owner of the property; a court confirmed that a mechanic's lien is enforceable against land where improvements have been made even if a business tenant, and not the true land-owning lessor, was the party that arranged for the work to be done.)[6]

As suggested earlier, these terms should be viewed as general guidelines; even a bond lease might be called simply a "net" lease in some discussions. The fairly unusual single net lease, or the double net lease, could be more suitable in a multiple tenant situation, and the lessee might directly pay a prorated share of costs for maintaining common areas. A triple net or bond lease often is best suited to a stand-alone building, which might have been built by the lessee (perhaps a retail chain) and then sold to the lessor under a "sale-leaseback" arrangement, with a long-term lease that gives the lessee fundamental control of the property while freeing up money to invest in its business operations rather than being tied up in real estate (and largely freeing the lessor from property management duties – an attractive feature for some investors). But problems can arise under a triple net or bond lease if the lessee does not sufficiently meet its maintenance obligations, particularly things like replacing mechanical system components, as the lease term's end approaches. With any type of longer-term net lease, the lessor is likely to directly pay local

property taxes and property/casualty insurance premiums to be assured that they were paid, but to make the payment with money ultimately collected from the lessee.

3. Index lease – with an escalation clause based on the CPI or other index, or maybe on the value of the property ("reappraisal lease") or the *ad valorem* taxes payable on it ("specific happenings increase"). (Instead of allowing rents to rise, an alternative could be a "stop" provision to limit expenses the landlord must incur.)

4. Percentage lease – common for retail property. Lessee pays to lessor a base rent plus a percentage of gross sales receipts, perhaps receipts exceeding a base level. (For an in-demand location the rent might be the greater of a fixed amount or a specified percentage of sales, so the lessor sees steady inflows even in slow sales periods.) This arrangement gives the lessor incentives to keep the property safe, attractive, and accessible so the lessee will draw more customers (in a facility like a shopping mall the lessor might even have contractual obligations to hold events that will promote sales). Problems: defining "sales" (usually means sales net of returns, but are gift-wrapping and other non-merchandise services included?), and verification of how much was sold. These problems have increased in the Internet sales era; for example, does a BOPIS (customer buys on-line, picks up in store) count as a sale toward rent the store owes the lessor? Do returns of goods to a store reduce the store's sales for rent purposes even if the purchase was made on-line from the store's parent company site? Another problem is that lessors with percentage leases can find loans harder to obtain, because lenders prefer the assurance of steady and predictable rent payments.

5. Agricultural lease – rent may be cash, a share of the crops produced, or a hybrid share-cash lease (Illinois has recently seen more cash rents that vary with crop yields). In recent years Midwestern farms have moved more and more from long-popular "crop share" arrangements to cash rents. One reason is that with increased mechanization and other modern farming tools, a farmer seeking enough land to farm efficiently may need to get it from multiple owners, and the splitting of costs that characterizes crop share could be complicated with one farmer lessee and multiple land owner lessors. [It is interesting that the farm land leasing idea has seen a 180 degree turn in some cases, with farmers increasing the financial returns from land they own by renting parts of it out to non-farmers: energy-producing companies, for solar fields and the siting of huge wind turbines.]

6. Sale-leaseback – a business builds or buys a building, sells it to an investor, then leases it back (likely under a long-term triple net or bond lease, as discussed earlier). This arrangement gives the seller/lessee financial flexibility; it gives the seller/lessee long-term control of the property without tying substantial money up in real estate, and gives the buyer/lessor a secure long-term investment. A similar arrangement is the "build-to-suit" lease, in which a land owner builds improvements for the needs of a particular tenant, which then rents the property under pre-negotiated terms. Bass Pro Shops agreed to pay $600,000 per year in rent under a Kansas build-to-suit lease in 2005, but then had an option to buy the facility for $10 when the 20-year lease ended.[7] Under Pennsylvania law a build-to-suit lease whose initial term plus options to renew give the lessee control for at least 30 years counts as real estate transfer, on which a transfer tax must be paid.[8]

[A financial benefit to a business that operates from rented facilities is that each period it can deduct from gross revenue, as a legitimate business expense in computing taxable income, all rent paid – as long as the dollar amount is "reasonable." Rent negotiated in an arms' length transaction between unrelated parties generally would be judged by the Internal Revenue Service to be reasonable, but if the parties are related (*e.g*., the lessor is an owner of the lessee business) the government would want to ascertain that the lessor is not benefiting illegally by charging unreasonably high rent. For example, someone who owns a small commercial building and also operates a small business could improperly pay herself an unrealistically high rent for the business to use the building, leaving less of a residual as salary on which she would have to pay Social Security and Medicare "payroll taxes." People who are substantial owners of small corporations have been found guilty of paying themselves unjustifiably low salaries, on which payroll taxes must be paid, and then getting higher income as dividends, on which those taxes are not owed.]

Sale-leaseback of houses? Amid Bloomington-Normal's tight housing supply conditions in late 2023, real estate broker Aaron Kull observed transactions in which people were willing to sell their homes only if the buyers agreed to close the sales and take ownership, but then lease the dwellings back to the sellers – giving those sellers added time to find houses they wanted to buy in the supply-constrained market.

7. Ground lease – a building is constructed on land that the contractor or ultimate building user leases – perhaps for 50 or even 99 years – rather than buys. It may occur because the owner of land in a desirable location is unwilling to sell it (may want the land to stay in her family indefinitely), or as a financing and tax planning tool (a business can realize income tax breaks on a building it owns by claiming annual depreciation deductions,

and realize an income tax break on the underlying land by deducting the lease payments – land can not be depreciated, so owning land might not be of great importance to the business as long as its control of that land is assured). Buildings on leased land generally would legally become property of the land owner at the lease term's end, although the practice with residential and some business property often seems to be for ground leases to be renewed. And it would not be unusual for a ground lease to have an escalation clause, with rent rising on an established schedule. Annual rent RFR Holding pays to Cooper Union college for use of the land on which New York City's iconic Chrysler Building sits went up from $7.75 million to $32.5 million in 2018, and is scheduled to rise in 2028 to $41 million,[9] almost a 530% increase in just over ten years.

Residences built on leased land, with regular rent payments owed to wealthy land-owning families, are common in England. Homes on nearby Lake Bloomington are, in fact, built on leased land, as is the conference center portion of the *Chateau Hotel and Conference Center* (leased for decades from the city of Bloomington for $1 per year). A September 2019 *Wall Street Journal* article discussed New York City co-op apartment buildings constructed on leased land; "maintenance" fees charged to each dwelling unit's occupant can include more than $4,000 per month that is passed along as rent to the land owner (but it is argued that buyers of the units pay lower prices accordingly, since they are not paying for land). Some southern California families own homes built on land leased from Native American tribes; the leases have 65-year terms that often can be renewed for periods of 25 to 34 years with federal government approval. Many banks will not make loans for the purchase of residences on leased land, and those that do typically limit the maturity of any such loan to 5 years less than the remaining term on the ground lease – thus when the ground lease's remaining term falls below 35 years it becomes difficult for people to buy (or refinance) with 30-year loans, and values of the properties can fall.

E. Transfer of Interests

The buyer of a leased property takes possession subject to the lease (you can not buy a leased building and then throw the lessee out), unless the lease specifies otherwise. Unless prohibited under the lease, a lessee's interest can be

1. *Assigned* – a third party takes possession and pays the rent, but the original lessee can still be held responsible if the assignee does not make payments.
2. *Sublet* – the original lessee turns possession over to a sublessee. Original lessee collects rent from the sublessee, and pays the lessor, unless the lessor agrees to deal directly with the sublessee. This situation sometimes arises unexpectedly, when a lessee wants to move to a different facility. (Lessors of office space faced competition during the 2020 Covid-19 shutdowns from some of their own larger lessees, which started subletting space they no longer needed as more employees were expected to continue working from their homes into the foreseeable future.) It also can arise from an intentional plan, under which a lessor shifts risks by leasing a large amount of space to a lessee, who then tries to profit by subleasing the space for more than the steady rent that lessee is paying to the lessor. (WeWork gained prominence pre-Covid by obtaining large amounts of office space under long-term, fixed-payment leases, and then renting it out under short-term leases to "co-working" tenants, often tech industry startups, that shared space with other firms. The company encountered problems over the high growth targets and reported extravagant lifestyle of founder Adam Neumann, and by late 2022 it was struggling as tech industry layoffs brought less need for office space – and more subleased space to have to compete with.
3. *Mortgaged* – if the leasehold has value (a leasehold has value, which might serve as collateral for the lessee to borrow money, if lease payments are to remain at less than market level rent over a long period; see section I at the end of this outline).

But – leases often specify that the lessee must get the lessor's permission to do any of these.

F. Lessor's remedies if lessee breaches lease agreement:

1. Sue for the delinquent rent.
2. Obtain a "distress for rent due" – lessor gets a court order and seizes the lessee's personal property.
3. Get a court order and *evict* the lessee. Of course, if the lessee is evicted (actual or constructive) his liability to pay rent ends. (If the lessee *abandons* the property, rent generally is still owed.)

G. A Few Special Points Regarding Leases on Commercial Real Estate

- The law tends to view business operators as parties with the sophistication to negotiate on equal terms with lessors, so generally there are fewer protections under the law for commercial property lessees than for residential lessees. Courts have held, for example, that a commercial site can be rented "as is," although the lessor can not misrepresent the property's condition (the implied warranty of habitability is replaced

by a weaker implied warranty of suitability for intended purpose, though an implied covenant of quiet enjoyment generally applies in both residential and commercial leases). The landlord's failure to perform repairs must be more severe than would be true under a residential lease for the lessee to withhold rent, but if the property's condition is bad enough a court could rule that a commercial lessee had been constructively evicted. A high-end New York men's store was found not to have suffered a *partial* constructive eviction (its owner had sought a reduction in rent) when renovations being done at the upscale hotel the store rented space from made it less accessible to hotel guests for many months. The court reasoned that a long-term lessee of commercial space must expect renovations to occur at some point, and that over the long run the store would benefit from being in an improved property.[10] But a Texas court ruled that a doctor could stop making office rent payments when the lessor's failure to make roof and other repairs led to mildew and rodent problems.

- In fact, because business property can involve such a wide range of uses, it often is more efficient for a new lessee to prepare the interior improvements for the desired use, typically with the landlord's approval of the plan, than to have the lessor do it and build the cost into the rent charged (the landlord might set a lower rent for some number of months as a "tenant improvement" allowance). Lessees of some types of commercial space likely know more about setting a property up for a specialized use (or know more specialized service providers) than the landlord does. If the lessor does make improvements for a new business property tenant, that lessee might receive favorable lease renewal terms since the lessor will not have to incur new setup costs.

  With a residential lease, on the other hand, the lessor generally handles all repairs and improvements before new lessees move in, and builds the cost of providing that service along with regular repairs and maintenance into lessees' rent payments – an outcome that generally would be more efficient than having new lessees take care of repairs, because residential property will be used the same way by most lessees, and the lessor likely would be able to deal with service providers more economically than a residential lessee, especially one new to the local area, could. However, there also appears to be a movement among residential landlords, more so those renting individual houses than apartment landlords (though it occurs with apartments also), to impose separate fees for services like video doorbells, having a mailbox, even trash removal and routine maintenance like changing furnace filters – akin to the separate fee structures at airlines and hotels.[11] It might actually be democratic for a lessor to state a basic rent and then have lessees who want non-essential add-ons pay for them separately, as long as market competition keeps the basic rent at an appropriately lower level. That would be especially true if, for example, a landlord said: you can pay us extra to handle that maintenance job, or you can handle it yourself or hire someone of your choosing (*vs.*: you are required to have it done, and must hire us to do it at our quoted price). This cafeteria approach gets us away from the longstanding idea that a residential landlord would want to do maintenance/repairs, and charge for the expected cost within the contract rent, to better assure that work is done correctly and prevent harm to the property.

  [Remember: when transactions occur everything has to be paid for, and society benefits when things are done more efficiently, with less money paid in reflection of fewer valuable and scarce resources being used up.]

- A commercial property tenant is likely to have both more responsibility to maintain the property, and more freedom to order emergency exterior repairs that the landlord must pay for, than would be the case with residential leases. A lease on commercial real estate should be clear in identifying which items the lessee installs are "trade fixtures" that the lessee takes when the lease ends (unlike typical fixtures that stay with the property), and about what happens if the property is destroyed (whether the lessee must still pay rent, and whether the landlord is required to rebuild).

- Investors view retail properties as more risky to purchase for sale-leaseback arrangements than manufacturing properties are, because rent is a higher proportion of total costs for retail than for manufacturing – so a retailer that gets into financial trouble would have greater incentive to seek ways to get out of its lease.[12]

- In an earlier discussion we noted that generally when a landlord sells income-producing real estate the lessees' leases remain intact. But when a landlord defaults on a loan, and the lender forecloses, the lessees' leases may be void, and the lessees will have to vacate the property unless new leases are negotiated with the lender that becomes the property's new owner. The issue can be whether the leases have priority over the loan or the loan has priority over the leases – which can be determined by which interest was recorded in the public records first. But the leases also can specify that the property lender agrees not to terminate the leases should it need to foreclose on the owner, and that the lessees will remain in place with the lender as the new owner. (Note that if the leases are void upon default the lessees could also leave voluntarily without such a

signed provision.) [Does it make sense that leases stay intact if the lessor sells the property but may be void if the lessor is foreclosed on by a lender? Think: who bears the cost of lease terms favorable to the lessee?]

- One legal source states that some commercial real estate leases, especially those involving new businesses, are month-to-month, which makes sense in light of start-up businesses' possible inability to make longer-term commitments – and these short-term leases need not be in writing under the statute of frauds to be enforceable in court (even if the month-to-month arrangement continues for many years). But as is usually the case: it is best to have written terms, so all parties' intentions are clear.

- Even shorter period leases are seen with hotel/motel properties – often just one day. This very-short-term arrangement allows the lessor to change terms based on market conditions: raise or lower the rents to reflect demand as more/fewer travelers visit the area for business (or based on specific events, like a home game weekend near a major football college). A news report stated that the 2023 Super Bowl, perhaps the biggest of all events for drawing in out-of-town visitors, had pushed daily revenue per Phoenix hotel room to $419, compared to $167 the previous February. However, Los Angeles area hotels suffered serious Super Bowl disappointment in 2022, with only 79% of available rooms occupied; not only had Air B&B-type rentals come to displace hotel usage to an increasing degree, but with the Rams playing in the game a large portion of the attending fan base lived locally and had no need for a place to stay.[13] Some analysts view a hotel as an inseparable combination of real estate and business values (like providing meeting facilities and catering for conferences).

  Short-term leases à la Air B&B are not universally embraced. Localities both in the U.S. and overseas have placed restrictions on those kinds of rentals for reasons that range from complaints by permanent residents about the rowdy behavior often seen with short-term visitors, to concerns that lucrative short-term leases can crowd out needed permanent rental housing. (Lessors in Italy counter that short-term rentals are less risky for them because laws make it so hard to evict long-term lessees who turn out to be difficult.) Many European cities limit the number of days yearly that a home can be rented out, while New York prohibits leasing an entire dwelling unit short-term, and the owner must be on site when the renters are present.[14] Interesting aside: a news report states that travel sites like Air B&B and Expedia make extra income by collecting payments from travelers as soon as they book facilities to rent, and then investing that money in short-term financial instruments until they pay the landlords when the travelers' stays begin – often months later. The increasing interest rate environment over much of 2022 was very beneficial to these travel sites.[15]

- Parties that rent underwater oyster beds from state agencies in Virginia are not entitled to compensation if pollutants from local sanitary districts leave the water unsuitable for oyster cultivation; as lessees they are deemed to assume the risk that the water will remain clean enough to use.[16]

- The Internet era has brought the leasing of shared office space, through "hoteling" (space shared among workers at the same company) and "co-working" (space shared among people working under the same roof but for different companies). WeWork (mentioned earlier) popularized co-working, but controversies that included lavish personal spending and a lack of profits led to founding CEO Adam Neumann's resignation and the company's need for a bailout by Japanese conglomerate Softbank in late 2019. Then in November 2023 WeWork filed for bankruptcy,[17] to get some relief from the long-term leases it was obligated to keep paying on while it was increasingly unable to sublet to shorter-term tenants (that was the company's business model).[18] Impact Hub and Industrious are other firms that have provided co-working space.

H. Use Caution

Leasing scams have grown in the Internet era – and especially scams involving apartment subleasing, often in college towns. An individual using a false identity claims, perhaps on Craigslist, to have an apartment to sublet, and asks for payment of a damage deposit and first month's rent in a form that can not be traced (wire transfer or cryptocurrency). Police advise verifying with the building's owner or manager that the individual exists and the sublet is legitimate, and encourage paying with a method that can be traced, like a personal check.

I. Leased Fee and Leasehold Values: Examples

At the beginning of this outline we noted that the market values of the leased fee and leasehold interests together generally would be expected to equal the market value of an unencumbered fee simple interest in the same property. If one of those estates rises in value because of an advantaged position, the disadvantaged estate's value should fall accordingly. The Empire State Building operates under a long-term "master lease" negotiated in 1961, with options

to renew for up to 114 years. A main tenant pays rent on the entire building to the leased fee holder, and subleases office space to businesses. As rents paid by occupying subtenants rose over the years the master leasehold soared in value, and the leased fee (receiving uncompetitively low rent) became worth relatively little. In the 1990s the leased fee was acquired by an investor group that included a pre-Presidential Donald Trump, while the master lease was held by a group that included famous New York real estate investors Harry and Leona Helmsley. Trump's group tried unsuccessfully to have the master lease voided by accusing the lessee of inadequate care of the building.[19]

Let's say that a parcel of land with a small commercial building would have a market value – the present value of expected market-level cash flows to the equity investor – of $400,000 if the fee simple interest could be purchased today, with no lease in place, by competing purchasers anxious to buy. However, this property is rented to a lessee user, so the fee simple estate has been broken into leased fee and leasehold components. If the lessee pays a market-level rent the leasehold's market value is $0 (the right to occupy real estate and pay a fair market rent generates no extra financial or market value; from an opportunity cost standpoint the lessee gains no advantage from the right to pay rent at the market level, and no value would be gained by subletting to another party if the market rent is what the lessee already is paying), and the leased fee market value is $400,000.

But consider what happens if instead the owner/landlord entered into a ten-year lease, at a fixed annual rent, with a lessee two years ago. The initially negotiated rent was in keeping with market rent levels at the time, but rents have been increasing in this local area, such that the rent the lessee is required to pay for the lease term's remaining eight years is $5,000 per year less than would be paid on a newly negotiated 8-year lease with fixed rent payments (let's say the negotiated rent is $62,000 per year but a market level of rent would be $67,000). The lessee thus receives a $5,000 annual economic benefit because of having a fairly long-term lease with below-market rents. If the typical market participant would distill the rent savings stream into a present value with a discount rate of 6% per year, a quick approximation of the absolute value of the PV of the annuity constituting the below-market rent obligations is

$$\$5{,}000\left(\frac{1-\left(\frac{1}{1.06}\right)^{8}}{.06}\right) = \$5{,}000\ (6.209794) = \$31{,}048.97,$$

or about $31,000. In this case the market value of the leasehold estate, benefiting from a lease that is favorable for the lessee, is $31,000; from an opportunity cost standpoint the current lessee pays less rent than competitors are paying for similar space, or note that the lessee could charge another user an amount approaching $31,000 for the right to sublease the property at the contract tent, in light of the higher rent that now prevails in the market. The leased fee, burdened with a lease that has become unfavorable for the landlord, has a $400,000 – $31,000 = $369,000 market value. The landlord would expect to be able to sell the property only at a price $31,000 less than the unencumbered fee simple value would be, because a buyer would willingly pay only the long-term value of the bricks and mortar (the present value of the cash flows expected by an owner, based on market-level revenues and expenses) *minus* the value loss from eight years of income lower by $5,000 than what similar competing properties would be expected to provide. The leased fee and leasehold values sum to the $400,000 fee simple value, if the typical lessor and lessee would apply the same discount rate to the stream of non-market rent payments. (We also assume that expenses borne by the lessor would not be affected by the lower revenue expected, such that the income capitalized into a present value differs from the case with market-level figures only by the below-market rents.)

Now consider instead a lease that was negotiated five years ago with a fifteen-year original term and a fixed annual rent. The market value of a fee simple interest in the property, unencumbered by a lease, would be $625,000. The initially negotiated rent reflected market rent levels at the time, but rents have been declining in this local area, such that what the lessee is required to pay, over the lease term's remaining ten years, is $3,250 per year more than would be paid on a newly negotiated 10-year lease with fixed rent payments. The lessor thus realizes a $3,250 annual economic benefit from having a fairly long-term lease with above-market rents. The lessee, who is stuck paying more rent for the next decade than would be owed if a new deal were entered into today, now has a leasehold interest with a negative market value; from an opportunity cost standpoint the current lessee must pay more in rent than competitors are paying for similar space, but in a competitive market can not pass that added cost along by charging higher prices to its customers, and thus earns less profit accordingly; or note that the lessee would have to pay someone a bonus to take over the rights to use the property if the sublessee then would be obligated to pay more rent than they could obtain similar premises for in today's market. But then the market value of the landlord's leased fee is more than the unencumbered fee simple's market value would be. If the typical transactor would use a 5% annual discount rate, a quick approximation of the absolute value of the PV of the annuity representing the stream of higher rent payments is

$$\$3{,}250\left(\frac{1-\left(\frac{1}{1.05}\right)^{10}}{.05}\right) = \$3{,}250\ (7.721735) = \$25{,}095.64,$$

or about $25,000. The market value of the lessee's leasehold estate, hurt by the obligation to make excessive rent payments, is – $25,000. So if the fee simple market value would be $625,000, the market value of the leased fee, benefiting from above-market rents the landlord gets to collect, is $625,000 + $25,000 = $650,000. The landlord would expect to be able to sell the property, in a competitive market, for more than the unencumbered fee simple value, because a buyer would get the long-term value of the bricks and mortar (the present value of the cash flows expected by the owner, based on market-level revenues and expenses) *plus* the added value of a ten-year special income boost, relative to what competing properties would be expected to offer. (And of course the leased fee's $650,000 market value plus the leasehold's – $25,000 market value sum to the unencumbered fee simple's $625,000 market value, if we can assume that typical parties on either side of the transaction would apply the same discount rate in computing their respective present values.)

These examples also help illustrate why longer-term leases often have escalation clauses that increase or decrease rents in keeping with a measure of the rate of inflation (although rent levels also can change with rising or falling demand for rented space based on business conditions in the local area, and not just because of national inflation measured by the CPI or other index used for rent escalation in a lease). If rents always adjusted quickly to new market levels the leasehold typically would have a zero market value, and the leased fee always would be worth the market value the fee simple interest would have if the property were not encumbered by a lease.

[Rents usually are due at the start of each payment period, so in computing the absolute value of the stream of above- or below-market rent payments technically we should use the present value of an annuity due factor, and perhaps should compute on a monthly basis since the higher or lower rent's impact generally would be realized monthly. For example, in the first case shown above the tenant might expect to gain the benefit of rent that is lower than market by ($5,000 ÷ 12) = $416.67 at the start of each month for 8 years = 96 months, discounted at a monthly rate of (.06 ÷ 12) = .005, for a present value of

$$\$416.67\left(\frac{1-\left(\frac{1}{1.005}\right)^{96}}{.005}\right)(1.005) = \$416.67\ (76.475694) = \$31{,}865.13.$$

A beginning-of-period cash flow assumption yields a PV absolute value higher than the $31,048.97 found above, but not too different. We know there is some guess work in identifying market rent for a particular property and the correct discount rate to use, so keeping the computations simpler with annual rent totals and the PV of an ordinary annuity factor can be a practical/sensible tradeoff.] •

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[2] https://www.ilga.gov/legislation/ilcs/ilcs3.asp?ActID=2201&ChapterID=62.
[3] *Timber Ridge v. Dietz* (New Jersey trial court, 1975).
[4] Moise, Imani. "In Tough Housing Market, Renters Renovate Like They Own the Place." *The Wall Street Journal*, December 1, 2022.
[5] *Amann v. Frederick* (North Dakota supreme court, 1977).
[6] *Vineyard Properties v. RLS Construction* (Utah appellate court, 2021).
[7] Mentioned in *Tax Appeal Protest of Arciterra BP Olathe KS, L.L.C.* (Kansas appellate court, 2021).
[8] Noted in *PSP NE, LLC v. Pennsylvania Prevailing Wage Appeals Board* (Pennsylvania district court, 2023).
[9] Grant, Peter and Smolak, Helena. "Signa Holding, Co-Owner of New York's Chrysler Building, Is Ordered to Sell Stake." *The Wall Street Journal*, December 20, 2023, B6.
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[11] Parker, Will. "Tenants See Fees Grow Along With Their Rents." *The Wall Street Journal*, September 6, 2023, A1, A6.
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[18] Saeedy, Alexander and Klein, Jodi Xu. "Wall Street Funds Discuss Potential Bankruptcy Plans for WeWork." *The Wall Street Journal*, August 24, 2023.
[19] Oser, Alan S. "Perspectives: The Empire State Building's Two-Front Campaign." *The New York Times*, July 21, 1996, 9-7.