

Legislative Relief for Ground Lease Cooperatives

By Deborah E. Riegel

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Perhaps the greatest uncertainty associated with ownership in a residential ground lease cooperative corporation is the question of ground rent escalations. Where the cooperative corporation leases the land on which a building has been constructed, in addition to traditional maintenance expenses for the operation of the building, shareholders are also responsible for their proportionate share of the ground rent due to the owner of the land. The method by which increases in ground rent are determined is a matter of contract, which varies by the terms of the individual ground lease. Because such increases are typically driven by market factors, rather than a fixed rent schedule, the increases are unpredictable.

In December 2023, Senator Liz Krueger introduced Senate Bill 7825, to create a new Section 223-c of the Real Property Law which, if enacted, would (1) limit rent increases under residential cooperative ground leases; (2) entitle residential ground lease cooperative

corporations to renew a ground lease for the same period as the expiring term, subject to the terms of the proposed legislation as to rent increases; (3) permit residential ground lease cooperative corporations to incur indebtedness or borrow money, notwithstanding any restrictions in a residential cooperative ground lease, to pay or fund additional rent (defined in the bill as amounts spent to comply with the residential cooperative ground lease for the payment of real estate taxes, insurance, repair, maintenance, including that required by the FISP program implemented by the city of New York or other municipalities, or for capital improvements to the residential ground lease apartment building); and (4) grant residential ground lease cooperative corporations a right of first refusal if the land owner intends to sell or otherwise transfer its interest in the property, all as more fully set forth below.



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Courtesy photo

The sponsor's memorandum of support justifies this legislation as a means of preserving what she describes as housing occupied by "middle-income residents on fixed incomes," notwithstanding that her Senate district encompasses some of the wealthiest zip codes in Manhattan.

Cooperative corporations and their shareholders allege that they are subjected to unpredictable and frequently significant rent increases when ground rents reset. Land owners oppose the bill as not only legislative overreach into an arm's length commercial contract, but also an unconstitutional violation of the contracts clause of the U.S. Constitution.

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It is worth noting that from a pure economic perspective, purchasers of residential ground lease cooperative apartments historically pay a fraction of the price that the same apartment would command in a residential cooperative that is not subject to a ground lease, precisely because of potential ground rent increases.

To achieve the sponsor's purpose, the bill prohibits annual increases in base rent payments (defined as any payments, other than additional rent, due to be paid under the applicable ground lease) which, exceed the greater of 3% or the consumer price index (maximum

annual rent increase percentage). However, to the extent that an annual increase in base rent, when added to increases in additional rent paid during the prior year, exceeds the maximum annual rent increase percentage, the increase is capped and such excess carries forward to the following year.

In the event the ground lease provides for increases in base rent on a periodic basis less frequently than annually, the increase in base rent for such period, when taken together with the amount of any increase in additional rent, may not exceed more than the compound increase that results from applying the maximum annual rent increase percentage for each applicable year above the base rent for the prior year in effect.

As such, owners of ground lease real property are subject to unbargained for limitations on rent increases, notwithstanding the extent to which expenses, including, most significantly real estate taxes, may exceed the maximum annual rent increase percentage. Put another way, the bill shifts the burden of increases in land costs to the owner of ground lease real property, rather than the shareholders who enjoy the use of that property.

In addition, by combining the maximum annual rent increase within a right for the residential ground lease cooperative to perpetual renewals, the bill also eliminates any possibility that the owner will be able to recover any lost revenue and simultaneously devalue the land for sale or other conveyance.

Residential ground lease cooperatives would also have the right to incur indebtedness and/or borrow money where the primary

purpose for such money is to help pay or fund additional rent or otherwise perform repairs, maintenance or other capital improvements to the building. Many ground leases restrict leasehold financing, such that residential ground lease cooperative boards are faced with imposing special assessments as their only means of capital funding.

With the increasing regulatory requirements on all cooperative corporations, including residential ground lease cooperatives, such as the costs associated with façade repairs, LL97 compliance and other regulatory schemes, an effort to make traditional financing available to residential ground lease cooperatives is intended to relieve the short term burden on shareholders and permit the cooperative corporation to fund necessary repairs and improvements through institutional financing.

While this may appear to have a less direct impact on landowners, to the extent that this provision also permanently overrides the bargained for terms of the residential cooperative ground lease and allows a residential ground lease cooperative to encumber the apartment building in which the landowner has a reversionary interest, it is also problematic.

The bill further mandates that a residential ground lease cooperative will have the absolute right to (1) renew its ground lease on the same terms and conditions, subject to the aforementioned rental increase limitations, at any time prior to or within ninety days after having received written notice from the ground-lease owner of the expiration of or termination of the ground lease, for a term equal to the length of the expiring term; and

(2) exercise a right of first refusal, where the owner proposes a sale or transfer of an interest in the ground lease real property.

The ground lease owner must provide the residential ground lease cooperative with written notice containing the price and all other terms and conditions of the proposed transfer and the residential ground lease cooperative would have the right to purchase the interest being conveyed at the same price and on “substantially” similar terms and conditions.

What constitutes “substantially” similar terms is not specified, and also is likely to engender litigation. For example, if an owner is presented with an “all-cash” offer to close “as-is” within 60 days, are the terms of purchase substantially similar if the cooperative corporation requires financing? Where a 60 day closing is proposed, but the bill gives a cooperative board 120 days to notify the owner of its intention to exercise its rights, can that exercise be on substantially similar terms when the owner must continue to bear the ground lease real property expenses for an additional four months?

These, and the other issues that will inevitably arise, are likely to be subject to litigation.

This bill follows the Legislature’s stated intention of increasing tenant protections, which began in 2019 with the enactment of the Housing Stability and Tenant Protection Act (HSTPA), and most recently includes the enactment of Good Cause Eviction, which limits rent increases for rental units not otherwise subject to rent regulation. Ironically, the maximum annual rent increases here are

substantially lower than even those ultimately approved by the Legislature when it enacted Good Cause Eviction.

While federal courts have, to date, declined to strike down rent regulation embodied in the HSTPA almost five years after its enactment, litigation over its constitutionality persists.

Further, just as the U.S. District Court for the Southern District of New York held that the Guaranty Law, enacted during the COVID-19 pandemic, ostensibly to provide relief to small business owners, violated the Contracts Clause, this bill facially suffers from the same infirmities.

The court invalidated the Guaranty Law in *Melendez v. City of New York*, 668 F.Supp.3d 184 (SDNY, March 31, 2023), based on, among other reasons, its conclusion that (1) the law was permanent, rather than temporary in nature; (2) placed the economic burden exclusively on landlords; (3) did not condition the relief on any financial need or hardship; and (4) made no effort to compensate landlords, who were asked to solely shoulder this burden, while retaining the obligation to continue

to pay their taxes and expenses without the contractually agreed upon income.

It is not difficult to anticipate a challenge which applies the *Melendez* analysis to this proposed legislation, with potentially the same results. Just as with the Guaranty Law, this bill seeks to permanently modify residential cooperative ground leases while placing the burden solely on the landowner, without compensation. It similarly applies to all residential ground lease cooperatives regardless of need or hardship—whether on the Upper East Side or in the Bronx.

As such, while cooperative boards and shareholders stand to benefit from the passage of this legislation and will certainly look to it to standardize expenses associated with residential cooperative ground leases, those benefits are far from assured and may only be achieved after years of litigation, with the associated expenses borne by the shareholders.

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