



Roosevelt Island Operating Corporation

ANDREW M. CUOMO
Governor

SUSAN G. ROSENTHAL
President & CEO

BOARD OF DIRECTORS
RuthAnne Visnauskas, Chair, Commissioner of NYSHCR
Robert F. Mujica Jr., Director of BUDGET
David Kraut
Howard Polivy
Michael Shinozaki

Agenda Item V, 1. June 25, 2019

PROPOSED RESOLUTION

AUTHORIZATION OF SEVENTH AMENDMENT TO MANHATTAN PARK LEASE

RESOLVED by the Board of Directors of the Roosevelt Island Operating Corporation of the State of New York, as follows:

- Section 1. that the Seventh Amendment to the Manhattan Park Lease, upon such terms and conditions substantially similar to those outlined in the Memorandum from Susan G. Rosenthal to Board of Directors dated May 20, 2019, attached hereto, is hereby authorized;
- Section 2. that the President/Chief Executive Officer or her designee is hereby authorized to take such actions and execute such instruments as she deems necessary to effectuate the foregoing; and
- Section 3. that this resolution shall take effect immediately.



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MEMO

TO: Board of Directors
FROM: Susan G. Rosenthal
DATE: May 20, 2019
RE: Seventh Amendment to Manhattan Park Lease

Background – Current Lease provisions

Roosevelt Island Associates (“RIA”) is the ground lessee under the Manhattan Park ground lease. The Manhattan Park ground lease has three separate rent periods. The lease is currently in the “Second Period”, where the rent is based on a fixed payment plus a percentage of the gross income received by the Tenant over a certain threshold.

The “Third Period” will begin in 2028. In 2028, the “Additional Payment” will be re-set to an amount equal to the “Appraised Rent”, less \$100,000¹, plus an amount equal to fifty percent (50%) of the gross Motorgate Revenue for each lease year. The “Appraised Rent” is the product of the “Appraised Value” times the “Applicable Percentage.” “Appraised Value” is defined as the fair market value of the Land and Buildings, based upon the highest and best use of the Land and Buildings (exclusive of Motorgate II). If the parties are unable to agree upon the Appraised Value, it will be determined in accordance with an appraisal proceeding. “Applicable Percentage” means a percentage that provides a “market rate of return to Landlord throughout the Appraisal Period.” The lease does not specify what percentage would constitute a “market rate of return to Landlord.” The rent will again re-set in 2043 and 2058, and there are no interim increases in between the rent re-sets in 2028, 2043 or 2058, nor is there any “floor”, that is, there is no provision that the rent as of any re-set date cannot be lower than the rent payable during the immediately preceding period.

RIA refinanced its mortgage in 2014. At that time, RIA indicated that it had great difficulty in finding a lender willing to make a long-term mortgage loan, given the uncertainty as what the Appraised Rent will be in 2028, in part because of the lack of a specified “Applicable Percentage”. As the lease term grows closer to 2028, RIA is concerned that it will be unable to refinance its mortgage in order to obtain funds to perform desired capital improvements in the residential buildings. RIA also expressed concern that valuing the property based upon the “highest and best use” of the property could lead to an unrealistically high valuation based on the potential use of the property for the construction of high-end condominiums, which would be unfair in light of the fact that RIA is obligated to use the property for residential rental purposes, with a Section 8 building.

¹ The deduction for \$100,000 accounts for the fact that the “Base Rent” consists of a \$100,000 payment of “Ground Rent” (which will continue to be due throughout the lease term) and an Additional Payment for each of the First, Second and Third Periods, calculated in the manner set forth in the lease. The discussion in this memo relates to the calculation of the Additional Payment for the Third Period.

Based on the difficulties it encountered in connection with its 2014 refinancing, RIA contacted RIOC in 2016, requesting that the parties agree to revise the lease so as to amend the provisions regarding calculation of Appraised Rent for the Third Period. (RIA also requested other changes in the lease as well, including renewing the request that the lease for the Section 8 building be severed from the lease for the market rate buildings. RIOC did not agree to the other requested changes, but, for reasons discussed below, was willing to engage in conversations about amending the rent re-set provision.) Negotiations on the requested change continued through early 2019. RIOC was advised during the course of negotiations by an appraiser, as well as a real estate consulting and appraisal firm.

As a result of these negotiations, RIA requested that RIOC agree to enter into a Seventh Amendment to the Manhattan Park ground lease, so as to modify the ground lease provisions regarding the rent re-set for the Third Period beginning in 2028, in order to provide greater certainty in the determination of rent. (These revisions relate only to the rent charged for the residential buildings; rent for Motorgate II will continue to be fifty percent (50%) of the Gross Motorgate II Revenue, as set forth in the ground lease.)

Proposed Revisions to Rent Re-Set Provision

Under the proposed revision to the rent re-set provisions for the Third Period, rent for the Third Period will be the sum of “(1) (i) the “Third Period Fixed Payment” (as defined below), less (ii) One Hundred Thousand Dollars (\$100,000), and (2) a percentage payment (the “Third Period Percentage Payment”) in an amount equal to fifty percent (50%) of the Gross Motorgate II Revenue for such Lease Year.” As noted above, the ‘Third Period Percentage Payment’ relating to Motorgate II remains unchanged from the current lease.

The “Third Period Fixed Payment” is the Appraised Rent, as it will be increased during the Third Period, as discussed below.

The revised clause provides a specified rate of return to RIOC of 2.75%, rather than an indeterminate “market rate of return.”

The definition of “Appraised Value” has also been revised to provide greater detail about the factors to be taken into account in determining the fair market value of the Land and Buildings (exclusive of Motorgate), providing greater guidance to the appraisers who will ultimately determine the Appraised Value, whether by way of a negotiation between the parties, or the appraisal procedure set forth in the lease.

Unlike the existing lease, the revised provision also provides for interim increases in between the rent re-set years of 2028, 2043 and 2058. Specifically, the initial “Third Period” rent re-set will take effect in 2028. Under the current lease, that rent determined in 2028 would remain in effect until the 2043 rent re-set, and that re-set rent would remain in effect until the 2058 rent re-set, which would remain in effect until the lease expires in 2068.

Under the proposed revision, the rent will increase in between the rent re-set dates as follows:

- (a) as of 2038, Third Period Fixed Payment will increase to 110% of the Third Period Fixed Payment payable for 2037;
- (b) as of 2048, the Third Period Fixed Rent will increase to 110% of the Third Period Fixed Payment payable during 2047;

(c) as of 2053, the Third Period Fixed Rent will increase to 110% of the Third Period Fixed Payment payable during 2052; and

(d) as of 2063, the Third Period Fixed Rent will increase to 110% of the Third Period Fixed Payment payable during 2062.

Also, as noted above, the current lease did not guaranty that the rent as of any rent re-set date will not decrease from the rent then being paid. The revised clause provides a floor, so that, in addition to the interim increases noted above, the rent as of any rent re-set date will never be lower than the rent payable in the immediately preceding lease year.

Discussion

As noted above, the Manhattan Park lease provides that “Appraised Value” means the fair market value of the Land and Buildings, based on the highest and best use of the Land and Buildings (exclusive of Motorgate) as of the appraisal Date. The lease does not state that the value is to be determined as if the land was unencumbered by the lease. Based on changes in case law since the Manhattan Park lease was signed in 1986, where a lease does not specifically state that the appraised value is to be determined as if unencumbered by the lease, the lease will be taken into consideration in determining the rent. Therefore, as the expiration date of the lease approaches, RIA could argue that the rent should be decreased as of the rent re-set dates. In the revised lease clause, RIA has agreed that, in determining the rent, the diminishing lease term will not be taken into account in determining rent, so that RIA can no longer argue that the rent should decrease as the lease term advances. (And, in fact, the revised clause does just the opposite, in that it specifically provides that the rent as of the first year of the Third Period, and each rent adjustment date thereafter, will not be lower than the rent paid in the immediately preceding lease year.)

Furthermore, it is unusual for a ground lease to provide for increases in the rent in between specified rent adjustment dates, as this revised clause does.

RIA has argued that, since it constructed the buildings, and is obligated to use them for residential rental buildings, with a Section 8 building, it is only fair that these uses be taken into account in determining rent, rather than to determine value based on a theoretical “highest and best use” that is not permitted under the lease. We believe that RIA’s position in this regard has merit.

In order to provide guidance and better certainty in determining the fair market value of the land and building, the appraisers are to take into account the actual rents and expenses as of that date, assuming that the buildings are 95% occupied. Providing for an assumed occupancy rate will prevent RIA from warehousing apartments in order to artificially depress the rent prior to an appraisal date. The size, age and condition of the buildings will also be taken into account in determining the rent, but adverse conditions resulting from RIA’s failure to prudently manage the buildings will not be taken into account, thereby discouraging RIA from failing to maintain the buildings in order to decrease the rent.

In addition to the provisions noted above, the revised clause also notes several other factors to be taken into account in determining rent which will be helpful to RIOC. These include providing that valuation will be based on the current size of the buildings (which is helpful if the buildings exceed the size then permissible under zoning) and the fact that RIA is not obligated to pay real estate taxes.

Additional Revision

In addition to the changes noted above, RIA has asked to include a new article entitled “Right of First Negotiation” in the Seventh Amendment. This Article mirrors a provision that has been included in many ground leases on Roosevelt Island. Essentially, if the term of RIOC’s Master Lease with the City of New York is extended beyond its current 2068 expiration date, RIOC agrees that, as of the later of (i) July 1, 2065, or (ii) 90 days after the Master Lease has been amended to extend the term, RIOC will negotiate in good faith to extend the term of this Lease at a then fair market rental rate, taking into account the improvements on the property and the use. In addition, if RIOC intends to sell its interest in Manhattan Park only, it will negotiate in good faith with RIA to sell such interest to RIA at a fair market price, taking into account the terms of the lease, and the improvements on the property and the use.

Recommendation

Every appraisal process carries with it an inherent risk of uncertainty, and the potential for litigation and legal fees. While this risk cannot be entirely eliminated, the risk of litigation and an adverse result can be reduced by enumerating the factors to be taken into account in appraising the rent and, for that reason we believe it to be in RIOC’s interest to enter into the proposed Seventh Amendment of Lease. Further, the concessions made by RIA during the course of negotiations (such as, periodic rent increases in addition to rent re-sets, and the agreement that the rent will never decrease during the term of the lease) are unusual in a typical ground lease, and will help provide a fair ground rent to RIOC through the end of the lease term.