

Alternatives to Site Acquisition

Ground Leases: An Overview

[by Joshua Stein]

When an owner doesn't want to sell a site but a developer wants to develop it, the parties sometimes will give the developer site control through a ground lease. This allows the owner to keep long-term ownership while receiving a rental stream that the owner regards as nearly equal in value to the site itself.

Because a ground lease can meet the needs of all the parties, it can bring about a development project that otherwise might never have occurred. Governmental bodies, universities and other public or

quasi-public property owners often use ground leases when they have a long-term development strategy for land they own, and want more control than an outright sale might leave them.

Private owners and investors sometimes use ground leases to transfer control of existing buildings where the owner wants to realize the value of its position rather than sell.

When the parties sign a ground lease, they must honor its terms for the life of the lease. The developer has no right to use or build on the site except for whatever rights the ground lease creates. Therefore, the terms of the ground lease need to justify substantial investment over a long period by both the developer and its lender. The ground lease should give the developer and its lender rights and benefits not too different from outright ownership, so long as someone pays the ground rent.

Ultimately, both the developer and its lender will want a package that the next investor will be willing to buy at an attractive price. If the ground lease has a problem, it can't necessarily be solved. This is why anyone using this structure, and their counsel, needs to be very familiar with the peculiar issues a ground lease creates.

Concerns

As in most other business transactions, the ground tenant's first concern will be pricing, i.e., the stream of ground rent the developer will have to pay to keep the site. Although almost every long-term ground lease will build in some rent increase mechanism, the resulting unpredictability can make the leasehold (the tenant's position under the lease) harder to appraise and hence harder to finance. If the ground rent rises faster than the true rental value of the site, or in a way that cannot reasonably be projected, then the developer may have trouble financing the project.

A developer will often prefer fixed dollar or percentage rent increases defined at the beginning of the lease term, but will probably tolerate periodic rent adjustments to reflect the then-current value of the site over time. These adjustments raise tricky issues that the ground lease must resolve with absolute clarity. For example, if the landlord delivers raw vacant land at the beginning of the lease, then the developer will want the rent adjustment to reflect only the value of raw vacant land — not the value of the developer's project. If the rent will increase to reflect the entire value of the project including the developer's building, then the developer will effectively lose its entire investment as soon as the rent resets.

Any reset formula must define exactly what is being valued, and answer questions like the following: How does the valuation reflect any change in zoning from the date the lease was signed? Does the valuation of the landlord's ownership position assume the continuation of the ground lease? What use of the leased site will be assumed? How do mortgages affect the valuation?

The answers to these questions will help determine whether the ground lease will remain valuable and economic to the developer over time. If the ground lease gets any of the answers wrong, the developer's position may be unfinanceable and worthless.

Recognize Risks

After the developer has signed off on the economics of a ground lease, the developer will want to know that a mortgage lender will accept it as collateral.

Unlike absolute ownership of real estate, a leasehold raises the risk that the lease might terminate early for any number of reasons, such as the developer's failure to pay rent, some other default or a prohibited assignment. In considering that risk,

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both the developer and its lender must assume that once the developer has finished construction, the landlord will look for any opportunity to pull the plug. The landlord will know that if it can terminate the lease, it will own the developer's project for free — a much more attractive package than the landlord's rental stream under the lease.

This incentive sometimes triggers litigation. For example, the ground landlord of the Empire State Building recently tried to terminate the building's ground lease on the theory that the tenant was not properly maintaining it. Similar incentives explain any landlord's unwillingness to amend a ground lease to correct any problem it might contain.

Both the developer and the lender therefore must assure that the developer's obligations under the lease are manageable and tolerable, and will make sense over the entire lease term. If the lease imposes too heavy a burden on the tenant, the tenant exposes itself and its lender to the risk that the landlord will be able to find some basis to cancel the lease.

The lender will want something more. It will want to know that if the developer somehow violates the lease or doesn't do what it promised, the lender can protect itself from an early termination of the lease. If the landlord can terminate the lease, the lender instantly loses all its collateral.

The lender will want the landlord to agree to notify the lender of any default by the tenant. The lender will want to be able to correct the problem. If the problem is one that the lender can't fix, the lender will want to be able to preserve the lease by paying the rent and foreclosing on its leasehold mortgage without correcting the problem.

Doing the Deal

A developer looking ahead to financing and refinancing the leasehold will want to include in the ground lease every possible protection that any future prospective lender might want.

The developer also should remember that market conditions can change dramatically during the lease. If the developer owned the site, it could tear down any building on the site; change an apartment building to an office building to a hotel; or do whatever else might make sense as market conditions and technology shift. In negotiating a ground lease, the developer and its lender will want similar flexibility.

The landlord will probably want just the opposite assurance that when the ground lease terminates and the landlord becomes the owner of the developer's project, the landlord will be satisfied with that project. This tension drives some of the most difficult negotiations in any ground lease.

Over the long term, the ground lease also needs to recognize that cataclysmic events can occur, like fires or a condemnation. In

those events, the ground lease needs to give the developer and its lender a fair monetary equivalent of what they would have received if the adverse event had not occurred. If not, the ground lease will leave open the possibility of a total loss of the leasehold investment (the developer's equity and the lender's loan), with nothing to replace it.

A ground lease also raises dozens of other issues, mostly variations on the themes suggested above. If the developer negotiates the right treatment of each issue, it should create a leasehold that is very much like ownership, subject only to an extra layer of payments much like real estate taxes. And if the developer keeps in mind a lender's agenda, the developer should also end up with collateral that a lender will be willing to finance. □

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