Development Rights: Lender's View

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As we all know, developers can acquire unused development potential from nearby properties that are underbuilt. People sometimes incorrectly refer to unused development potential as "F.A.R." But F.A.R. is just the abbreviation for "floor area ratio," which is only one variable in the formula that defines development rights. In a city of skyscrapers, an acquisition of unused development rights can allow a New York developer to build higher than otherwise, thus often making much more money.

Unused development rights trade for $500 to $600 per square foot at prime sites, or up to $1,000 per square foot at "ultra" prime sites, according to Eric Anton of HFF, who puts together many of these deals. Even at these prices, development rights usually trade for less per square foot of development potential than land, so can represent a great investment for the developer.

It seems intuitively obvious that any construction or pre-construction lender ought to be happy to lend against the incremental value that the developer can create by buying development rights. If done right, it works that way. But based on my experience, some lenders and developers don't quite understand how the trade in development rights works and what makes good collateral.

Caroline Harris, a partner at GoldmanHarris LLC, a boutique law firm that handles zoning matters, says the first misconception about "air rights" (a colloquial name for development rights) is that they are somehow "free floating" in the air. They aren't. They must be appurtenant to a particular piece of property. Development rights start at a granting site, after which the developer must move them to a receiving site. Until that happens, the developer can't realize value from the development rights and a lender shouldn't treat them as meaningful collateral.

That means, in turn, that the only way to lend against development rights is to lend against the receiving site. And if that receiving site already has a mortgage on it, as it inevitably will, it's not practical for some new lender to separately finance the development rights. The developer's

overall financing package for the receiving site needs to provide for it—and it will, if done right.

Can we finance development rights separately by putting them into some other borrowing entity? Or can we create a valuable contract for the future transfer of development rights? Can we then have a new lender lend to that separate entity or take that contract as collateral? Not really. The transferred development rights just need to become part of the developer's receiving site, and they can't be separated from the rest of the receiving site. A contract to acquire development rights, even at a great price, will have value only if one definitively knows the contract will close, and the development rights will go to the receiving site.

As a variation, Ms. Harris says a developer might acquire only the part of a site that is more than a certain distance above ground level. The developer might then temporarily "park" unused development rights there. That gets the purchase of development rights successfully closed. But it still doesn't make them financeable, because the developer still can't actually use them in a project.

Most transfers of development rights require compliance with some tedious technical requirements. For example, the sites need to touch for at least ten feet; they can't have certain code compliance or title problems; lenders and other "parties in interest" need to consent; and the zoning lot documentation must comply with specific city requirements. Once all that happens, the granting site and the receiving site (and potentially others) become a single "zoning lot," within which any otherwise existing development potential can be moved around to a certain degree.

Once a developer successfully transfers development rights to a receiving site, doing so still does not assure creation of new value. Just having the right to build more square footage doesn't mean the developer will actually be able to do it. Height limits may apply. Zoning and other laws may limit the configuration of any possible project.

In one recent case, for example, it turned out that the developer couldn't use all the development rights it had acquired, unless the developer could get control of an adjacent site. Until then, the development rights had no value. But the developer had no potential to sell them to anyone else. To prevent such a problem, Ms. Harris says, a developer needs to play through and analyze the entire development plan, looking ten steps ahead in the chess game, before agreeing to buy development rights.

As another trap, not all development rights are the same. Different zoning districts allow a square foot of land to support different amounts of commercial, community facility and residential development. If a district allows more commercial than residential development, Ms. Harris notes that a seller might have used up its residential allotment and have only commercial rights to sell. That doesn't help a residential developer.

How a lender approaches all of this partly depends on the type of loan. If the lender is financing the beginning of an assemblage, the lender may care more about the existing improvements and collateral than the developer's plans—including future acquisitions of development rights—because as a practical matter, the lender has no assurance that the rest of the project will come together as hoped. In contrast, a construction lender financing an entire project will require absolute certainty that the developer has made it past the roadblocks mentioned here. The loan closing process and due diligence—and early consultation with zoning advisers—will typically make sure that happens. Or one could move to Houston, which famously has no zoning code and is nevertheless, for the most part, perfectly nice.

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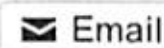
submit 

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