

Comforting the Condemned

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Anyone who creates, negotiates, buys, sells or finances a long-term ground lease is condemned to having to think about condemnation, the possibility that some government will decide the leased property would make a great location for an army base, a tunnel entrance, a municipal garage or the like.

Condemnation may not happen much. But it does happen. And lenders worry about it a lot. If a ground lease doesn't deal with condemnation reasonably, then it may not be financeable.

Many ground leases say that landlord and tenant will share any condemnation payment based on a formula, taking into account the rent, the remaining term, the cost of the building, some dollar figure for the land, and perhaps other things. Any such formulaic amount might approximate the fair market value of the landlord's or the tenant's position at the time of condemnation, if it were sold in an arm's length transaction without regard to any condemnation. (Let's call this "true value.") More likely, though, it would not. Instead, the formulaic payment would probably exceed or fall short of true value, which could create a corresponding windfall for the other party.

To prevent that anomaly, many ground leases say the condemnation payment goes first to the landowner, up to the true value of the owner's position. Everything else goes to the tenant. Each party's lender always gets first claim to whatever their borrower receives.

That allocation makes sense because the landowner's position is functionally equivalent to a first mortgage, giving the landowner first claim to property income, up to the amount of the ground rent. If the ground rent doesn't get paid, the landowner evicts the ground tenant and gets everything. And the condemnation payment largely represents a capitalization of future income, plus something for the value of the building when the lease ends. Just as the owner has first claim to each year's income, so too should the owner have first claim to the capitalized value of that income in the form of a condemnation payment.

That sounds great for the landowner—and probably represents the most common way to resolve the issue—but what if the government doesn't pay as much as the leased property is really worth? The ground tenant would suffer the whole shortfall. One could say that's the same risk borrowers face when they put a mortgage on their property, and it's just too bad.

When the tenant pledges its interest in the lease as security for a loan, though, the tenant's lender might not agree. The tenant's lender would say that it should have first claim to any condemnation payment until its loan has been repaid. Only then can the land owner get anything. That's because the tenant's lender makes the entire transaction possible, providing the capital that creates value for all.

The landowner usually responds to that argument by telling the tenant to have its lender underwrite the condemnation shortfall risk just like any other valuation risk, or buy insurance to cover it. People who sell that insurance will say the risk of a shortfall is huge. The government's condemnation lawyers, on the other hand, will say condemnation awards and settlements are overly generous. The issue, though, is not really the magnitude of the risk, but how we should allocate it.

Sometimes, the tenant or its lender sticks to its guns and prevails, perhaps with limits on the tenant's loan. This shifts much of the shortfall risk to the landowner, turning on its head the proposition that the landowner is functionally just like a first mortgage holder.

As another approach, the landowner and the ground tenant might share any condemnation payment—as well as the shortfall risk and the possible windfall of an overly generous payment—in proportion to the true value of each party's interest in the lease. This treats the whole issue as a “real estate risk” that both parties own in proportion to their interests in the real estate.

A simple proportional distribution of any condemnation payment could simplify the discussion and reduce the stakes if a condemnation ever occurred. My conversations with the rating agencies indicate it would not interfere with securitization of either the landlord's or the tenant's loan. It avoids any need for great minds to develop an allocation formula that will inevitably be wrong. It has the advantage of simplicity and perhaps fairness. It does require two appraisals at the time of condemnation. Appraisals are always imperfect. But we live with that all the time in real estate.

Metaphorically, this approach puts landlord and tenant in the same boat. They share in a reasonable proportion the risks associated with their shared boat. They ignore arguments to give one party or the other priority. The landlord doesn't get a “full” first claim to the condemnation payment, but neither does the tenant's lender. All parties involved get a reasonable claim. And everyone can go think about other things.

Joshua Stein is the sole principal of Joshua Stein PLLC. The views expressed here are his own. He can be reached at joshua@joshuastein.com.

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