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The Explosion of Developments Under Ground-Lease Structures

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In a long-term ground-lease structure, a private party or governmental entity owns a development site, leases the land to a developer and receives rent over the term of the lease. This structure has become a very common element in the US real estate market. Ground leases have historically appeared in certain locations, such as the UK (where many residential and commercial properties are ground-leased under the "landed estates" concept by entities such as the Crown Estate, the Church of England and London's trade associations (liveries), and in the US in the state of Hawaii, where much of the developable property is owned by land trusts whose primary goal is to retain ownership of the land and lease it for development. The potential benefits to a private or public landowner of retaining ownership and control of land, limiting the risks of development, and sharing in the profits of a development have been hard to ignore, resulting in an increasing level of ground-lease transactions throughout the US.

For landowners, a ground-lease structure creates plenty of benefits. A successful development project by the ground tenant creates a long-term secure passive income stream. Long-term ownership is retained. Control over development can be exercised, a critical issue for public land owners. Ownership of the improvements vests in the landowner at the end of the lease term. A lease as opposed to a sale avoids the payment of capital gains tax, though rent will be taxed as ordinary income.

For ground tenants, the advantages may not be as great. The ground lease may impose development limitations or obligations, including time limits for development, that would not otherwise exist. But a ground lease does create one major advantage for any developer: it eliminates any need to acquire the land. Instead, the ground lease effectively finances the land cost, potentially at a lower rate than the cost of traditional or non-traditional financing. Also, a developer cannot claim depreciation on any investment in land, so a ground lease allows a developer to better deploy funds that might otherwise be used to acquire the land.

A developer must also consider some other burdens of a ground lease, such as use restrictions, development and timing requirements, and other property-related obligations demanded by the landowner. Additionally, depending on the term of the leasehold, the value of the project to the ground tenant will decline over time.

A landowner also faces some risks in any ground lease. For example, because the landowner retains ownership of the property, it could face tort liability to injured third parties and vicarious environmental liability due to property contamination caused by the tenant or anyone else. Those risks can be mitigated, but not eliminated, through insurance and indemnification. And, of course, there is the risk that the developer will fail to complete construction, or the developer's project will fail in some other way, leading to litigation and, in the worst case, mechanics' lien foreclosures by unpaid contractors, perhaps even jeopardising the landowner's interest in the property.

Public-entity landowners have become more appreciative of a ground-lease structure as an alternative to sale. In addition to realising the economic benefits of a public/private partnership, public landowners can try to achieve social goals in a proprietary capacity that can go beyond what they may do in their governmental capacity. These can include imposition of architectural and design requirements, affordable housing requirements in rental housing developments, local and disadvantaged worker hiring obligations, prevailing wage requirements, and other public benefits, such as public parking, day-care facilities, community rooms, and bicycle storage and repair operations. The ground-lease structure can allow the governmental entity to impose these costs on the developer in exchange for the developer's paying less rent, thus avoiding the scrutiny and challenges that might arise if the costs appeared in an actual governmental budget.

Critical elements to consider and negotiate in a ground-lease transaction include:

- term;
- ground rent payments;
- participation payments to the landowner upon sale or refinancing;
- assurance that a lender will accept the leasehold as collateral for substantial non-recourse financing;
- the relationship between the ground lease and any operating subleases;
- obligations to develop, upgrade or refresh the property, and assurances that the tenant will start, finish and pay for the work within a reasonable time frame;
- transfer restrictions; and
- the implications of a casualty or governmental condemnation.

LEASE TERM

The term of a development ground lease must be long enough to give the developer-tenant sufficient time to entitle, construct and operate the project so that it is economically attractive to enter into the lease. A lender to the developer-tenant will also have a keen interest in the length of the term, because it directly affects the value and strength of the lender's security, which consists only of the leasehold, not the landowner's interest in the property. Lenders will require, at a minimum, that the loan amortisation period be significantly shorter than the remaining lease term. For example, if a loan will amortise over 30 years, the lender may want to see a remaining lease term of at least 40 years. The later in the lease term a leasehold loan is made, the shorter the amortisation period and the higher the debt service payments will be. At a certain point the leasehold becomes unfinanceable.

Public entity landowners may have statutory constraints on the lease term they can deliver. For example, California municipalities cannot sign ground leases for longer than, eg, 50, 55 or 66 years. Generally, one would see ground-lease terms of between 50 and 99 years for any new development project to be viable. The extent of the capital investment (and the reasonable return on investment), the potential useful life of the improvements and the bargaining power of the parties will determine the ultimate lease term.

RENT STRUCTURES

Any ground tenant and its lender would ideally like to see a ground rent obligation that is entirely defined from the beginning, such as $100,000 a year, rising by 2 per cent every year until the end of the lease term. Landowners worry, though, that over the many decades of the lease term, the economy may again experience inflation or even hyperinflation. That worry is partly driven by occasional ground leases signed in, eg, the 1950s at rent levels that seem silly today. Thus, today's landowners may not only demand annual small bumps (eg, 2 per cent); they also often demand some mechanism to adjust rent periodically to bring it into line with inflation or property appreciation.

That mechanism has traditionally often taken the form of revaluing the leased site, as if it were vacant land, and then adjusting the rent to equal some percentage, typically 6 per cent or so, of that revalued land. In recent years, real estate valuations in major US cities have used capitalisation (or discount) rates well below 6 per cent. The disconnect between current historically low cap rates and a 6 per cent rent constant has recently produced unpleasant surprises for many ground tenants, with the result that developers negotiating new ground leases have tried to move away from that formula. They have also tried to constrain the assumptions to be used in appraising the hypothetical vacant land. For example, instead of assuming it can be used for its "highest and best use" – which will maximise land value and, therefore, ground rent to the landowner – they may require the appraiser to assume the land can only be used for a specified purpose, eg, matching the then-current use of the developer's improvements, and also subject to any constraints in the ground lease on development and use. The developer seeks to prevent the risk of an uneconomic ground rent at the time of adjustment.

In some cases, the 6 per cent formula will be replaced by a formula based on inflation, ie, the consumer price index or some other price index.

Developers sometimes propose a formula based on a percentage of gross revenue or some other measure of the property's financial performance. That type of rent structure protects the ground tenant from having to pay an uneconomic rent, and thus has a theoretical logic and fairness to it. In practice, however, it can become very complex to structure. The landowner must worry about the potential to game the system and the possibility that the developer will make stupid decisions. Meanwhile, the developer must worry about seeking proper recognition for its initial (and future) investment in the property to maximise gross revenue for the "shared benefit" of the parties. It will typically make sense to give the landowner a small percentage of a "gross" measure of revenue, with as few exclusions and deductions as possible, avoiding the complexity involved in constructing a formula based on net revenue or profit. But that means the ground tenant/developer might pay percentage rent even though the ground tenant/developer's bottom line cash flow is negative.

The variations on these themes are endless. For example, the lease might contemplate minimum rent plus percentage rent. The percentages could vary based on different uses permitted by the ground lease. The entire negotiation takes place against the backdrop of trying to assure that the ground tenant and its leasehold lender can reasonably project ground rent going into the future so that the lender can predict and preserve a required debt service coverage ratio. The uncertainty of projecting future percentage rent payments, or the uncertainty of projecting future rent revaluations, may result in less loan proceeds for the developer or even an unfinanceable leasehold.

Whatever rent formula the parties agree upon, they usually agree to abate some or all of the rent during the ground tenant's anticipated construction period, a period when the tenant has no revenue. From the landowner's perspective, that abatement represents an indirect capital investment in the project, to be recovered from higher rents later in the lease term.

APPRECIATION PARTICIPATION FEATURE

In addition to the economic benefit of the regular rental stream often tied to project operations as described above, many landowners may view that return as insufficient compensation for the contribution of land to the project, and will negotiate an additional rent return based on appreciation in value of the project, payable upon a sale or refinance of the project. Ground leases by public entity landowners will often include this feature.

In a sale transaction, a typical structure would require the developer to pay the greater of a percentage of the gross sale consideration (eg, 2 per cent to 5 per cent), or a percentage of the net proceeds (profit) (eg, 10 per cent to 20 per cent). Tenants generally attempt to avoid the percentage of gross sale consideration part of the formula since it does not necessarily reflect profitability and could result in payment from a return of capital investment. The definition of "net proceeds" is critical so that payment to the landowner is based on true profit and not a return of capital. One would expect to deduct from the gross sale consideration all costs the ground tenant incurred for the development – legal, soft and hard costs – as well as any costs incurred in connection with the sale, including closing costs, loan prepayment penalties, etc. The formula can be complex, but the goal, simply stated, is that the landowner shares in profit, but not a return of capital. If a "net proceeds share" is payable upon a transfer, a later net proceeds share payable upon a sale would be based upon the new gross sale consideration less the sum of the prior sale price, improvement costs during the initial transferee's ownership and costs incurred in connection with the new sale.

In a refinance transaction, the landowner's goal is to receive a percentage of the profit similar to what it would receive had the leasehold been sold. Instead of a sale price as the gross consideration, the principal amount of the new loan would be the consideration received. The tenant could then subtract from that development costs and closing costs in determining the net refinance proceeds, a percentage of which would be payable to the landowner.

The developer's goal, often achieved, is to assure that in any sale or refinancing the developer can deduct enough costs that the landowner will never receive a penny of appreciation rent. Conversely, the landowner will want to protect itself and limit the deductions. The net result, if fully thought through, may look very much like the internal revenue code. Of course, it will be difficult to avoid the ultimate payment of appreciation rent upon a sale if the project is very successful. Many equity investors in the ground tenant entity will require a sale at some point consistent with their investment return objectives and timing horizon.

LEASEHOLD LENDER CONCERNS

Any developer negotiating a ground lease for a vacant site will want to know that a construction lender and, later, a permanent lender will accept the ground lease as collateral for substantial non-recourse financing. At inception, the lease may have no value as collateral or otherwise, because the ground rent equals the rental value of the site. Over time, the leasehold will become attractive as collateral because:

- the ground rent will, in many cases, fall below fair market rental value;
- the ground tenant/developer will build valuable improvements that will generate rent from space tenants, significantly in excess of the ground rent; and those improvements will attract higher rents and thus appreciate.

That increase in value will, the developer hopes, support increasing amounts of leasehold financing over time, starting with a construction loan.

Any lender to a ground tenant under a ground lease will worry, however, that any leasehold carries with it some special risks – starting with the fundamental risk that, if the ground tenant defaults, the lease might terminate and as a result the lender will lose all its collateral, ie, the loan will become unsecured and, if non-recourse, a gift to the ground tenant borrower. So any “financeable” ground lease must contain about a dozen protections for leasehold mortgagees, such as the right to step in and cure any default by the tenant; the ability to prevent the ground lease from being amended without the lender’s consent; and the right to receive a new lease in replacement for the original lease if the tenant files bankruptcy and rejects the lease. These measures and a handful of others generally seek to preserve the lease as valuable collateral, and are quite well defined and standard at this point.

Beyond the typical leasehold mortgagee protections, any lender will also consider all the other terms of the lease to assure that it will be attractive to future investors if the lender ever acquires it through foreclosure and resells it. In this regard, the lender’s agenda does not vary much from the developer/ground tenant’s, and the developer/ground tenant can often point to the concerns of a future leasehold mortgagee to strengthen its negotiating position on economic terms.

SUBLEASE PROTECTION

Subtenants – the economic drivers of the project – will want their own protection from landowner/ground-tenant disputes and lease termination. A ground tenant may attempt to negotiate a blanket obligation by the landowner to recognise and honour (“non-disturb”) all subleases if the ground lease terminates, to maximise the ground tenant’s space-leasing programme. Most landowners will, however, require that certain conditions be met as a condition to “non-disturbing” a sublease. Those conditions may include approval of the subtenant and the form of the sublease, and compliance with minimum economic requirements. A careful landowner will want to protect itself from any obligation to protect subleases that may be undesirable, fraudulent or burdensome.

LENDER RELATIONSHIP

Just as the ground tenant will finance the development of its project by obtaining a leasehold mortgage loan, the landowner will often obtain a loan secured by its fee interest and an assignment of rent generated by the ground lease. Many fee lenders will require that any lease on the secured property be subordinate to its mortgage. If the fee mortgagee were to foreclose, this could conceivably terminate the ground lease. This creates an obvious problem for the ground tenant and leasehold lender and is antithetical to its leasehold lender protections. The interaction between these two players can lead to extensive negotiations over the conditions under which the fee lender would not disturb the lease (and therefore the leasehold lender’s position). However, since the leasehold lender is the financier of the improvements that created the rental income, it is entitled to absolute protection from a foreclosure of the fee mortgage. That protection can be provided by assuring that the ground lease and any amendments thereto will always be superior to any fee mortgage. Since the fee mortgagee would have approved the ground lease before closing its loan, the fee mortgagee should, and typically does, agree to the priority of the ground lease and assuage the concerns of the leasehold lender. But it is an issue.

CONSTRUCTION AND CONTINUING CAPITAL OBLIGATIONS

The deal structure for any long-term ground lease will typically contemplate that the developer will construct a valuable income-producing project, which will create value in the ground lease, effectively giving the landowner a huge security deposit to assure payment of rent. So the landowner wants to know that the tenant will start, finish and pay for its initial project or any future major redevelopment. The comfort for initial construction typically takes the form of a completion guaranty from a creditworthy guarantor: the tenant’s parent company or financial investor. The scope, terms and credit support for that guaranty will constitute the second-most important issue (after the rent) in ground lease negotiations. Weak developers will offer a variety of measures to assure completion, but they typically do not give the landowner as much comfort as a completion guaranty from a highly creditworthy guarantor with a suitable net worth.

After completion, rent payments will still depend on property performance. Thus, landowners have a significant interest in ensuring appropriate and timely capital improvements and upgrades, as well as periodic renovations to maintain a competitive standard. Landowners may in some cases require that the ground tenant establish certain reserves for these purposes, accessible by the ground tenant when the work is in process, and easily monitored by the landowner. In other cases, the lease will establish continued standards the tenant must satisfy over time. In most cases, though, the landowner will rely on the ground tenant's profit incentive after completion of the initial development, based on the propositions that:

- the completed building gives the landowner all the comfort it needs; and
- after completion, the ground tenant should have as much flexibility and discretion as if it owned the building outright.

TRANSFER/ASSIGNMENT

The landowner will want to control the ability of the ground tenant to transfer the leasehold and improvements, particularly during the initial construction and lease-up phases, if the landowner entered into the ground lease based on the identity of the ground tenant, as will typically be the case. Thereafter the ground tenant, due at least in part to the requirements of its equity investors, will need flexibility to assign the lease. For its protection the landowner will want the right to consent to the assignment. The parties may agree on the standards for the assignee, such as the ability to handle the financial obligations under the lease, experience in operation and management of similar properties, and good citizen requirements. A ground tenant will want to negotiate as wide open a right to assign as possible, as long as the ground tenant has completed and paid for the initial development project and the assignee meets a short list of objective and clear, not subjective or vague, standards.

CASUALTY AND CONDEMNATION

While carefully crafted insurance provisions and requirements can handle the vast majority of potential casualty occurrences (fire, etc), careful consideration must be given to a possible uninsured casualty. Whether, when and under what circumstances a ground tenant may have an option to either rebuild or terminate – and if terminated, what demolition/removal obligations will be placed on the ground tenant – can be the subject of considerable negotiation. Similarly, the ground lease must consider the possibility that some public entity will acquire the entire property by eminent domain. The ground lease must allocate any resulting payment between landowner and tenant, and above all their lenders, in a sensible way that recognises the value and nature of the parties' interests.

Although a ground-lease transaction can add a level of complexity to real estate development and challenges to a landowner and ground tenant and their respective lenders, a carefully considered approach on behalf of each of the parties will lead to an appropriate allocation of risk and ultimate reward. A landowner, whether public or private, need not sell in order to realise the economic benefit from its land. Instead, the ground-lease structure presents an opportunity for a long-term income stream with the development and operational work undertaken by a developer under the ground lease.