New York Law Journal
Real Estate Trends
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An ALM Publication
VOLUME 242—NO. 125
WEDNESDAY, DECEMBER 30, 2009

GROUND LEASES

Crafting Rent Provisions Requires a Careful Approach

By Steven Simkin And Barry Langman

A common ownership arrangement in Manhattan, though perhaps little-known to the public, involves the use of a ground lease. The apparent owner of the property—the landlord of an office building, the business owner at a retail location or even the cooperative corporation at a co-op apartment house—may not in fact hold the fee interest at all, but may instead hold the lessee interest under a ground lease.

Ground lease transactions are typically characterized by a long-term lease of land that is undeveloped at the time of lease execution, or of land that contains improvements that are intended to be demolished to permit redevelopment. The term is typically 75 or 99 years, which is long enough to approximate or exceed the useful life of the improvements the ground lessee intends to construct on the property. Further mimicking actual ownership by the lessee, ground leases are triple-net, with the ground lessee fully responsible for taxes, insurance and operating expenses, as well as having considerable discretion over alterations and management at the property. A "financeable" ground lease will also accommodate the ground lessee's obtaining a leasehold mortgage, balancing the lender's requirements for secure collateral with the owner's concern that its fee position not be subordinated to the lessee's financing.

Particularly given the dramatic shifts in the real estate market in recent years, and the unpredictability of interest rates, inflation, taxes and other economic factors going forward, greater attention is being focused on ground leases. Customary terms are being reviewed in light of current conditions, and during challenging times entering into new ground leases may become an even more widespread way for parties to develop property. A complete grasp of the economics of these long-term transactions is an indispensable aid to maximizing their advantages and avoiding unexpected consequences.

For the landowner, a ground lease may be preferable to a sale of property in that it would avoid taxation on the built-in gains if the landowner has a low tax basis. Furthermore, the ground lease may aid in estate planning by permitting a step-up in basis upon the owner's death. Another benefit of a ground lease is that it may foster redevelopment of the property even where there are limitations on the owner's right or willingness to sell (e.g., if the owner is a public authority) or on the owner's development experience or tolerance for risk. Arguably the biggest advantage to a landowner is the simple fact of the ultimate security in a ground lease transaction: the property itself, which returns to the owner's control (as improved by the ground lessee's development) if the ground lessee should default or upon the expiration of the lease term.

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For the ground lessee, entering into a ground lease instead of buying a property can provide a relatively inexpensive means of financing the acquisition, with lower up-front costs than the lessee would incur if it were the buyer under a traditional purchase and financing transaction. Especially under current conditions, when financing can be difficult to obtain (and may require a large equity commitment), this alternative can be quite valuable. Additionally, in cases where the land is owned (and continues to be owned) by a governmental entity, tax and zoning advantages may be passed along to the ground lessee in a way that would be unavailable if it owned the fee interest.

The most significant issue facing owners and ground lessees in ground lease transactions is, of course, rent. Both parties want to enter into a beneficial deal, but with a term of 75 or 99 years it is difficult—if not impossible—to fix rental rates that will remain appropriate over the course of decades. The landowner must ensure that the rent not be rendered unreasonably low by the vicissitudes of inflation and/or market factors during a long lease term. Meanwhile, the ground lessee and its lender need to guard against future rent adjustments that could render the project uneconomical, and also want the predictability of rents that remain stable for extended periods.

Therefore, parties will commonly split the base rental provisions of the ground lease into several distinct periods.

First, there may be free rent (or a significantly reduced and/or stepped rent) during the anticipated construction period for the new improvements. This gives the ground lessee an opportunity to minimize costs while income from space tenants or an operating business is not flowing in, as well as greater flexibility with its construction financing.

For some time after the construction period, the ground lease may provide for an initial fixed rent as set at the time of execution. This rate will generally represent a fair rate of return on the value of the land as determined at the time the ground lease is signed.

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The ground lease may provide inflation adjustments from time to time—for example, increases every five years based on the Consumer Price Index. Sometimes the parties will agree to caps or collars to these

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adjustments (such as a maximum of an annual 5 percent increase or a minimum 2 percent increase) in order to provide more predictability. However, as the ground lease term goes on adjustments of this type may begin to seem somewhat arbitrary, since inflation rates may not accurately reflect the real estate market. In any event, they tend to make future rates of ground rent difficult to foresee and are problematic for a leasehold lender looking to forecast net operating income from the project. Thus increases based on the CPI are an inadequate mechanism for determining rent in the long term.

As a result, ground leases will often provide for periodic revaluation of the property, leading to a rent reset at a stated percentage of land value (i.e., the price a willing purchaser would pay to buy the property from a willing seller). For instance, a ground lease may provide that the rent is to be modified every 25 years to be equal to 6 percent of the fair market value of the land.

A key question, then, is how the valuation is to work.

The ground lease will generally provide, in detail, the procedure that is to be followed. Common ground lease provisions will set forth the applicable time periods, the number of arbitrators or appraisers, their qualifications, whether hearings will be held and if and how written reports and rebuttals are to be submitted. It is also standard for the ground lease to specify the procedure for coming to a decision; for example, in so-called "baseball" arbitration, the arbitrators may select only between the parties' respective determinations, without any ability to "split the difference" or choose another valuation.

The parties must keep in mind that the particular method of the valuation—including whether it is being done by appraisers, arbitrators or others—may significantly influence its outcome. Traditionally, there are three approaches to valuation employed by appraisers (which approaches may or may not be used by the professionals engaged to determine value):

- The Cost Approach is used to arrive at a market value by computing the current cost of replacing an improvement and deducting any accrued depreciation resulting from one or more of the following factors: physical deterioration, functional obsolescence and external obsolescence. That figure, combined with an adequate return for entrepreneurial effort, is added to the land value to arrive at a value for the whole property. The cost approach is often best suited to new or recently constructed properties with a minimum amount of accrued depreciation, and therefore would be inappropriate for most ground lease valuations.
- The Income Capitalization Approach is based upon the principle of anticipation, which posits that value is created by the expectation of future benefits. Annual cash flows and sale proceeds over a reasonable holding period are discounted to present value using rates of return derived from yields anticipated by recent buyers of similar real estate. This approach is generally not available when dealing with vacant land valuations.
- The Sales Comparison Approach is based on the principle of substitution, since a prudent purchaser would pay no more for a particular property than the price necessary for the acquisition of a substitute property which offers equal utility. The appraiser gathers data on sales of comparable properties and analyzes the nature, condition, date and other relevant factors of each sale, making subjective adjustments for dissimilar characteristics. Unless reliable information on sales of similar properties is not readily available, the sales comparison approach is the preferred method of valuation.

In the absence of good sale comparisons in the marketplace, appraisers may use a *residual* value analysis. This method, a variant of the income capitalization approach, looks to determine the value of the land as the value of the completed and stabilized improvement, less the development costs and developer's profit. However, vast amount of data are required for a residual value analysis—depending upon the perceived highest and best use, inputs may be required from experts in zoning, construction, leasing, financing, sales (whether residential, retail or office, as the case may be) and capital markets. This method is also very sensitive to subjective assumptions and forecasts, including those relating to future costs, rates of return, interest rates, discount and capitalization rates, market conditions for the project going forward, and numerous other factors that may be little more than conjecture.

No matter which valuation approach is used, land use regulations play a pivotal role, as changes in zoning after the date of the original ground lease (such as downzoning or, alternatively, increases in development rights by virtue of inclusionary housing bonuses or the purchase of air rights) may radically alter the value of the property.

No matter which valuation approach is used, land use regulations play a pivotal role, as changes in zoning after the date of the original ground lease (such as downzoning or, alternatively, increases in development rights by virtue of inclusionary housing bonuses or the purchase of air rights) may radically alter the value of the property. New York courts have concluded that, absent an agreement to the contrary, zoning restrictions *at the time of the valuation* (i.e., not at the time of the initial ground lease transaction) should be considered when determining the value of land. See *New York Overnight Partners, L.P. v. Gordon*, 217 A.D. 2d 20 (1995) (the fact that the site had been downzoned since the lease was signed was a factor to be taken into account in determining value); *201-203 Lexington Ave. Corp. v. 205/215 Lexington Limited Partnership*, 224 A.D. 2d 183 (1996) (the fact that the land was to be valued "free from all encumbrances and restrictions" did not exclude consideration of zoning laws in determining value).

Another important element the parties must address is whether the valuation is to consider the property as vacant, unimproved and unencumbered, or whether it should be valued subject to the ground lease. New York case law suggests that "absent an agreement to the contrary, the effect of a net lease must be considered in valuing property for the purpose of setting rent for a renewal lease term." *936 Second Ave. L.P. v. Second Corp. Dev. Co.*, 10 N.Y. 3d 628 (2008); accord *New York Overnight Partners*, id. ("[w]hen the language of the lease so dictates, appraisals must take into consideration all restrictions…as well as the lease term"). However, this direction by the *New York Overnight Partners* court to consider the remaining lease term may complicate a valuation when the ground lease does not specify that the property is to be considered free of the lease, because if the remaining term of the lease is to be considered in determining the value of the land, then the valuation may actually be of the estate for years that remain under the lease, not the value of the land itself. See Breitel J. dissenting in *United Equities Inc. v. Mardordic Realty Co. Inc.*, 8 A.D. 2d 398 (1959). Thus it is crucial in drafting these provisions that the parties articulate their business deal, to avoid the confusion and uncertainty that may result.

In part because of the infrequency and vagaries of valuations, a further possibility that owners and ground lessees should bear in mind in setting ground lease rent provisions would be including participation provisions. Such terms—which grant the landowner a share of certain profits—serve as a means to permit the landowner to share in the economic benefits to be derived from the property while assuring the ground lessee that the ground rent will remain affordable based on the income actually produced by the project. Because participation rent would provide the landowner a source of revenue that is in addition to the base rent (as determined by reappraisal), it gives the parties the opportunity to place less emphasis on base rent provisions.

In determining how a participating lease would operate, several factors must be taken into account. First is the percentage rate itself, which may be affected by the nature of the tenant's project and the earnings stream to which it is applied. Next, the parties must determine what that agreed percentage is applied to. For example, should it be a factor of gross revenue, cash flow before debt service or net cash flow? How are sale proceeds or refinancing proceeds to be treated? When the applicable amount is a net amount and not gross revenue, allowable deductions and exclusions become a critical focus of negotiations. Lastly, the parties may agree on a "breakpoint"—a hurdle that the project must overcome before the landowner's right to share in profits is triggered.

As noted above, a ground lease can provide numerous benefits to landowners and developers. The analysis in this article is just an introduction to the subject matter, and is of course vastly simplified. In working with a real-world ground lease—which is bound to involve various nuances and complexities—it is critically important to take a careful, thoughtful and knowledgeable approach to the rent provisions. Doing so will help the parties achieve their respective goals despite the unpredictability of the future, and minimize the ambiguities that arise when the document is less than clear.

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