New York Law Journal
Real Estate Update
Wednesday, July 13, 2005
ALM

Tailoring Rental Terms

Profit Sharing Accounts for New Development

BY STEVEN SIMKIN AND MANUEL E. LAUREDO

Commercial real estate practitioners frequently struggle with deciding how to adjust the fixed rental under a ground lease in the context of a new development. Common approaches to this issue include adjusting or resetting ground rents at regular intervals by reference to (i) predetermined increases, (ii) increases in inflation indices, or (iii) an appraisal of the fair market value of the land.[1] While these solutions offer readily ascertainable rental adjustments, all are relatively insensitive to the value of the underlying project being created because ground rent is adjusted by reference to fixed formulas without regard to the income or profits being generated from the particular project. Profit sharing provisions in ground leases for new developments, on the other hand, offer a far more tailored mechanism for addressing the concerns of landlords and tenants in resetting ground rent over the course of a lengthy ground lease term. This article will discuss some of the principal issues (and pitfalls) raised by profit sharing provisions in development ground leases that are based on (x) net cash flow derived from operations and (y) net proceeds from transfers of interests in and financings of, the tenant's leasehold estate.

Net Cash Flow

Structuring a provision in which the landlord will share a percentage of the net cash flow of a ground-leased development (i.e., the positive difference between a project's gross revenues and operating expenses) is a fact-driven exercise. Nevertheless, there are a number of principal issues (and traps) that arise in most such transactions that the parties should be aware of. The first tug of war between the parties involves defining what is included, excluded and/or deducted from "gross revenues" and "operating expenses" of the project. The landlord must make

Steven Simkin *is a partner at Paul, Weiss, Rifkind, Wharton & Garrison LLP and chair of the firm's real estate department.* **Manuel E. Lauredo** *is an associate at the firm.* **Allen M. Wieder**, *a counsel, contributed to this article.*

GROUND LEASE RENTAL

Steven Simkin

Manuel E. Lauredo

sure that the gross revenue definition is broad enough to include any and all direct and indirect sources of income or other economic benefits received by the tenant (and its affiliates) from or related to the project's operations, including but not limited to (i) rental income from subtenants, licensees and other occupants of the premises, and (ii) receipts from providing goods and services at or in connection with the premises to any person. While the foregoing categories are straightforward, the landlord should also be mindful of hidden benefits to the tenant which should be expressly addressed in the gross revenues definition. For example, the fair market rental value of any use or occupancy of the premises by the tenant or any of its affiliates, as well as any difference between the rents received from the tenant and the sublease rents tenant receives from third parties, should be imputed as gross revenues.

Conversely, the tenant must pay close attention to items that should be excluded from gross revenues, so as to avoid double-counting or capturing items which are not truly revenues from operations. Prime examples include distributions to and capital contributions by, the tenant investors and principals. In the case of transactions with affiliates, such as brokerage and management arrangements or work performed pursuant to subtenant work allowances, the tenant should also make sure that the receipts are counted as gross revenues only to the extent they exceed what is normally paid to third parties in arm's length transactions for comparable work or services.

The foregoing assumptions should also govern the parties' approach to defining operating expenses, although their roles reverse in respect of seeking to amplify or narrow the scope of this definition. The tenant should seek to capture all costs and expenses which are attributable to the use, maintenance, repair and operation of the project, including but not limited to (i) fixed rent paid pursuant to the ground lease, (ii) capital expenditures, (iii) repairs and maintenance, (iv) taxes and other impositions, (v) insurance premiums and deductibles, (vi) utilities and fuel costs, (vii) management and leasing costs, (viii) administrative and other overhead expenses, and (ix) the cost of work done pursuant to subleases. As with gross revenues, the landlord must exercise caution in reviewing operating expense items in order to capture areas which the tenant may exploit to reduce the net cash flow calculation. For example, any amounts payable to tenant-affiliates, such as brokerage, management and development fees, should be expressly limited to the amounts customarily paid to unaffiliated third parties in arm's length transactions for comparable items or services in a business operation of the size, nature and locality of the premises. Similarly, items such as those described in clause (viii) above should be scrutinized so as to disregard expenses which are unrelated to the premises or arise primarily from tenant internal or organizational operations. Also, operating expenses should not include (x) depreciation and other non-cash charges, (y) capital expenditures or other costs which are paid out of proceeds of a loan, reserves, or insurance proceeds or condemnation awards, assuming that the underlying debt service, reserve payments and insurance premiums are already treated as operating expenses and/or (z) late charges, penalties or interest for taxes, impositions and insurance.

A final component of operating expense which the parties need to pay close attention to is how to account for debt service and returns on the capital contributed by the tenant's investors. In this regard, the landlord should make sure that (i) the debt service which is included as an operating expense is derived exclusively from loans made by unaffiliated parties expended on the premises, (ii) that the amortization of such payments is long enough (or deemed to be long enough) to control for its impact on net cash flow and (iii) that the principal amount of the underlying loan does not exceed the amount properly allocable to the hard and soft costs of the

project's development (or is otherwise subject to landlord's sharing of net proceeds, as discussed later). In addition, the landlord should provide that the annual return on tenant's equity which may be counted as an operating expense is based on the amount of unsecured capital contributed by tenant's investors which is actually spent on development costs, which amount should be reduced by the annual net cash flow distributed to such investors from whatever source.

Implicit in the foregoing discussion regarding the scope of the net cash flow calculation is the need for the parties to address certain mechanics for ensuring its fair application, especially considering the danger of improper inflation and double-counting of gross revenues and expenses. For the landlord, this means requiring that percentage rent payments be accompanied by annual certified statements of net cash flow, gross revenues and operating expenses of the project, as well as the amount of tenant's remaining equity, each of which should be corroborated by an audit performed by an independent firm of public accountants, if necessary. For the tenant, this means ensuring that negative net cash flow is credited toward positive net cash flow in future periods, as well as requesting a dispute resolution mechanism that will ensure that disagreements over the payment of percentage rent will not result in forfeiture of the leasehold estate.

Net Proceeds

Net cash flow derived from operations presents only one area where a landlord under a development ground lease can share in the success of a particular project. Ground leases will typically permit the tenant to (A) exit the project after substantial completion of the improvements to be constructed, pursuant to (i) an assignment of its leasehold estate or pursuant to a sale of direct or indirect equity interests in tenant or (ii) a sublease of all or substantially all of the leased premises (hereinafter referred to as a "major sublease"), and/or (B) refinance its leasehold estate beyond what is needed to repay existing debt and cover future capital expenses. To the extent that these events generate positive cash flow to the tenant, landlords under development ground leases should endeavor to share in these revenues. As with the net cash flow concept, the most equitable way to determine the landlord's share of such proceeds or profits while protecting a project's economics is to express it as a percentage of net proceeds (i.e., the excess of all proceeds from a sale, major lease or financing (hereinafter referred to as "total receipts"), over the transferor's cost or "basis").

Drafting the definition of "total receipts" is a tricky exercise much like determining gross revenues in a percentage rent provision. From the landlord's perspective, total receipts should encompass all the consideration paid to tenant in connection with the transactions described in clauses (A) and (B) of the preceding paragraph, including (i) cash, (ii) marketable securities, (iii) the fair market value of any property received and/or (iv) the principal amount of any loan assumed or satisfied, as well as the face amount of any purchase money note or debt obligation accepted by the tenant or other transferor, in connection therewith. With regard to major subleases, the landlord will also want to draft the total receipts definition so as to capture any excess rental payable under a major sublease and each of its underlying subleases over the rent payable under the ground lease and the major sublease, respectively. This is to prevent the tenant from circumventing the sharing provision by subleasing the premises to itself or an affiliate in lieu of a sale or other transfer and then profiting by the spread between the major sublease and the aggregate rents payable under all of the further sub-subleases of portions of the property.

On the other hand, the tenant should limit the scope of how eligible transfers are defined to exclude transactions which do not cause a change in control or beneficial ownership of the leasehold estate (e.g., assignments to wholly-owned subsidiaries or sister entities), and equity dispositions within its ownership structure which are not effectuated solely for the purpose of transferring an interest in the project (e.g., transfers of stock or membership interests in investors which are public companies or funds owning a portfolio of investments). In this regard, the tenant may also want to distinguish between the dilution of interests in its ownership structure by existing investors, and the sale of such interests or the creation of new interests in favor of non-affiliates. Further, the tenant will want to exclude loan proceeds to the extent they are used to pay for capital expenditures or to fund reserves. The tenant should also seek to deduct the transaction costs incurred in connection with the foregoing transfers, while the landlord should try to limit that deduction to amounts customarily paid to third parties in arm's length transactions. Lastly, the timing of payments of total receipts should be taken into account, so that the landlord shares in net proceeds only at the closing of title to the interest being conveyed, or in the case of installment sales and major subleases, at the time payments are made to the tenant or other transferor.

Ground Lease profit sharing provisions are extremely complex and require careful thought and drafting to accomplish the desired objectives.

"Basis" for the purpose of calculating net proceeds derived from a particular sale or other transfer should be defined (i) in the case of an assignment or major sublease, as the development costs paid by the tenant and its affiliates, less the amortized amount of any loan or any cost which has been counted as an operating expense (so as to avoid including items which have been paid or reimbursed through the percentage rent clause), or (ii) in the case of a financing, as the principal amount of the loan being satisfied or refinanced. Since equity dispositions could also be included as events that generate net proceeds, the transferor's basis in these instances should be limited to the amount of consideration paid by the transferor for its interest in the tenant (or its proportionate share of development costs, absent other consideration), including the principal amount of any debt satisfied or assumed by such investor in connection with its initial investment, less any amortization of such principal amount prior to the effective date of the equity disposition. A key issue with regard to determining a transferor's basis is to account for the interaction between the net cash flow and net proceeds calculations, so as to avoid double counting. For example, to the extent that negative cash flow in one period is used by the tenant to offset the positive cash flow payable to the landlord in future periods, the same should not be added to the tenant's basis in connection with a transfer of its interests. Similarly, the tenant should make sure to provide that each transferor's basis "steps-up" as a consequence of each subsequent transfer for which a proceeds payment was made to the landlord. As previously discussed, certified statements regarding the transferor's total receipts and basis, as well as a dispute resolution mechanism, should be required in order to minimize triggering an event of default by reason of any disagreements.

Conclusion

Ground Lease profit sharing provisions are extremely complex and require careful thought and drafting to accomplish the desired objectives. Nevertheless, they may help to facilitate transactions where the tenant needs to limit its exposure to arbitrary increases in fixed rents by application of preset formulas and the landowner is reluctant to commit its property on a long-term basis without a way to share in the success of the development.

1. See generally, Jerome D. Whalen, COMMERCIAL GROUND LEASES §§2:4-3 (Practising Law Institute 2nd ed., 3rd prtg. 2004) (discussing fixed rent escalation and percentage rent clauses).

This article is reprinted with permission from the July 13, 2005 edition of the NEW YORK LAW JOURNAL. © 2005 ALM Properties, Inc. All rights reserved. Further duplication without permission is prohibited. For information, contact ALM Reprint Department at 800-888-8300 x6111. #070-07-05-0015