GROUND LEASES

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NEGOTIATING LEASES
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BIOGRAPHICAL SKETCH

J. Cary Barton is a graduate of Baylor University (B.A. 1962) and Harvard Law School (LL.B. 1965) and was admitted to the State Bar of Texas in 1965. He worked for several federal governmental agencies following his graduation from law school and served in the United States Air Force during the U.S.S. Pueblo crisis in Korea. He has been engaged in the private practice of law in Texas since 1969. He is currently a member of Barton Benson Jones PLLC, a ten-lawyer firm in San Antonio, Texas. He is Board Certified in Commercial Real Estate Law by the Texas Board of Legal Specialization and a fellow of the American College of Real Estate Lawyers. His law practice consists primarily of representing real estate developers and investors in commercial real estate financing transactions.

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UNIQUE ISSUES RELATED TO GROUND LEASES

I. INTRODUCTION

The objective of this presentation is to describe the more common aspects of a typical ground lease that may not be encountered in connection with traditional occupancy leases or which may present different considerations than those which would arise when dealing with such an occupancy lease. The model scenario which will be discussed here involves an unimproved tract of land which the parties contemplate the tenant will develop with improvements at some time during the term of the proposed ground lease.

II. REASONS FOR USING GROUND LEASE

A. Land Owner's Motivations

A land owner may have several motivations for choosing to use a ground lease instead of an outright sale of a parcel of land. One motivation may be a desire to preserve the opportunity to participate in the anticipated appreciation in value of the land over the term of the ground lease and to be able to pass that appreciated value to a future generation of the landlord's family.

Where the land has a relatively low basis for tax purposes, another motivation may be a desire to benefit from a rental rate determined on the basis of the entire current fair market value of the land without having to pay capital gains tax reflecting the appreciation in value of the property and losing the income-earning potential of that portion of the appreciated value which would otherwise be required to defray such tax liability.

Where the land has a relatively low basis for tax purposes and is encumbered by debt in excess of that basis, the land owner may also want to avoid a sale where such a large portion of the sale proceeds is required to defray the debt that the taxes payable on the sale will require a great portion of, or even exceed, the net cash sale proceeds available for paying those taxes.

Where the prospective tenant is sufficiently credit-worthy, the land owner may also contemplate encumbering the fee interest in the land to secure a loan which will be amortized from the rental payments under the ground lease. Such an approach will allow the land owner to realize a substantial portion of the benefits of a sale or refinancing for liquidity purposes without experiencing the adverse tax consequences noted above.

A land owner who owns other land in the vicinity of the property involved in a particular transaction may have concerns over how the subject tract will be developed in the future. Using a ground lease for the subject tract may permit the land owner to exert more controls over the development of that tract than would be available through the use of restrictive covenants imposed in conjunction with an outright sale of the tract.

In some situations, the land owner may be able to negotiate a participating ground rental structure under which the landlord will benefit from future income generated on the leased tract. That can be particularly attractive to a land owner which controls a prime tract of land and wants to benefit economically from the development of the land without incurring the development risks associated with improving the land.

B. Developer's Motivations

A developer will usually have one primary motive for suggesting the use of a ground lease instead of an outright purchase of a tract of land which the developer plans to improve. That motivation is the ability to avoid having to obtain the cash purchase price for the land from a lender or investor or the developer's own resources. It is assumed, of course, that the rental rate under a ground lease will ordinarily approximate the same cost of money that the developer would anticipate having to pay if the purchase price for the land were obtained from such other sources. In the ground lease context, however, the developer does not have to undertake the burden of paying back a principal amount or capital contribution equal to the cash price which would have been required to purchase the land. Ultimately, admittedly, the aggregate amount of ground lease rentals will almost always exceed the total of interest and principal payments the developer would have been required to pay in connection with an outright purchase of the land. That result occurs over a long period of time, though, which far exceeds the usual planning horizon of most developments.

There is also a tax incentive for the developer to use a ground lease instead of borrowing the money to purchase the land. The rental payments under the ground lease will be fully-deductible for federal income tax purposes, while the principal component of debt service installments will not be deductible. Moreover, the investment in the purchase of the land itself is non-depreciable for tax purposes.

In some situations, a developer may have another motivation for wanting to use a ground lease. Those situations arise when, despite the considerations discussed further below, the land owner can be persuaded to subordinate its interest in the ground lease to the liens securing the developer's construction financing. In such circumstances, the value of the land can be used as additional equity for the developer's project in underwriting the developer's construction loan. That procedure can be expected to reduce the amount of equity which the developer might otherwise be required to obtain or provide from other sources.

III. FINANCING CONSIDERATIONS

A. Subordination versus Unsubordination In Ground Lease

As noted previously, a developer will often ask the land owner to subordinate its interest in a ground lease to the liens securing the developer's construction financing for the contemplated development project. Such a subordination will certainly make it easier for the developer to obtain such construction financing and, in fact, may be critical to the construction lender's favorable underwriting of particular loans to particular developers. From the land owner's perspective, however, the question which must be asked is whether the benefits of the proposed ground lease are sufficient to outweigh the greatly increased risks to which the land owner is exposed by such subordination.

If the interest of the landlord under the ground lease is subordinated to the liens securing the developer's construction financing, a default by the developer on the construction financing will permit the construction lender to wipe out the landlord's interest in the land by foreclosing the liens securing the developer's financing. Even if protective features for the benefit of the landlord are incorporated into the subordination provisions, many of those features will require that the landlord become responsible in some fashion or another for the construction financing. Since avoiding responsibility for such construction financing may have been one of the landlord's initial motivations for the transaction in the first place, the landlord is not going to be happy if that eventuality should occur. If a land owner agrees to subordinate its interest to liens in favor of the construction lender despite these risks, the protective

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