

EXCLUSIVE: DEVELOPMENT GROUND LEASES ARE NO LONGER A NICHE

By Carrie Rossenfeld

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After the Great Depression, development ground leases fell out of favor for many years, but the use of ground-lease transactions has grown dramatically over the past three decades, according to Ira J. Waldman, a partner with Cox, Castle & Nicholson LLP in the firm's Los Angeles office. The following column, written by Waldman exclusively for SoCal Real Estate, explains how ground leases have evolved and what to know if you're considering one.

Development of land pursuant to a long-term ground lease from a landowner has been a development tool harking back to the "landed estates" era in the United Kingdom and the development of projects under trust ownership of Hawaiian land. In the continental United States, ground leasing as a means for development was not uncommon prior to the Great

Depression, but fell into disuse thereafter. Once the economy recovered from that devastation, ground leasing has been on a steady rise. But what really caused an accelerated use of ground leases as a development technique in Southern California over the past 25 to 30 years has been the interest of all manner of public and quasi-public entities such as cities, counties, Native American tribes, school districts, water districts, universities, and governmental development corporations who own land not being put to productive use.

The common factor for private and public landowners is the unwillingness of the landowner to sell, combined with a desire to maximize a secure current revenue stream that, for private landowners, may be passed on to future generations. Since a ground-lease transaction can be complicated — attempting to account for the interests of the landowner, developer tenant, operating subtenants, and the lenders to the landowner and developer — a developer would rather own than lease the land, all things being equal. But if the alternative is to pass on a potentially profitable project, developers will deal with the complexity and attempt to structure a ground lease that will work for its development concept, investors, and lenders.

There are several reasons for the growth in such transactions over the past 25 to 30 years. For public and quasi-public entities, ground leases offer a pragmatic solution to the advent of Proposition 13 and limitations on governmental income streams, combined with political pressures not to sell public property. Leasing land for development, more typically a private entrepreneurial endeavor, has become a mechanism for raising public funds, with many ancillary public-policy benefits. These benefits include control over development and design greater than might be available through zoning and land-use laws, establishment of hiring obligations (local, veterans, etc.), requiring the use of union labor and/or compliance with prevailing wage laws.

For private parties, which today may include labor unions, religious institutions, and other nonprofits, retaining ownership of land with the ability to create a secure income stream without material investment — and, at the end of the lease having ownership of the potentially valuable improvements revert to the landowner — can be enticing. As private landowners have seen the development of all manner of projects by private developers on public land, and the creative income streams that have been created, the enticement to mirror the economic benefits negotiated by the public entities can be irresistible. In fact, there are now several investment funds, such as Safety, Income & Growth, Inc., which is expressly created for the purpose of acquiring and investing in land subject to a ground lease.

In Southern California, many cities and counties are involved on the public side of ground-lease developments, particularly up and down the coast from Ventura Harbor to Marina del Rey to Newport Beach to San Diego. Typically, the public entity will start with a request-for-qualifications process followed by a request-for-proposals (RFP) process in connection with the selection of a prospective developer/ground tenant. The RFP will typically contain a description of the anticipated project, a statement of objectives, and a general description of the economic benefits expected by the public landowner.

This process has also been adopted in many private landowner scenarios. Once a developer is selected, the lease is negotiated, often with an option to which the lease is to be attached. For a public landowner, as a result of legal decisions precluding a public entity from “contracting away” its governmental approval rights, the documentation cannot be executed until the conclusion of the California Environmental Quality Act process, either through the issuance of an environmental-impact report or mitigated-negative declaration.

The downside for a developer in a public/private transaction is the obligation to spend time, money and effort without the assurance of a binding transaction. A private-party transaction may have such obligations, but at least there is a binding contract between the parties.

Economically, the ground lease will provide for several elements of compensation to the landowner. These can include 1) a relatively low holding rent while the project entitlements are pursued, 2) a somewhat higher construction period rent during the construction phase, 3) a minimum rent following completion (which can escalate through stabilization), 4) a percentage rent based on gross revenue generated by the project, 5) periodic adjustments to the minimum rent based on a rolling average of total rent (minimum and percentage) paid over several years, and 6) payments on transfers of the leasehold or future financings based on, and limited by, the net profit to the developer.

Many landowners will require periodic adjustments to fair market rent, or fair market percentages for percentage rent, often settled by a dispute-resolution process if there is no agreement. Most importantly, the underwriting concerns of a lender to the developer/tenant will tend to moderate the timing and scope of any rental adjustments.

There are many legal issues to consider and resolve in a development ground-lease transaction as the interests of all parties are considered. These include 1) construction (performance

schedules), maintenance and repair obligations; 2) transfer rights and restrictions; 3) the relative rights of the parties upon a casualty and condemnation, including reconstruction obligations; 4) the protections required by a leasehold lender to the developer; and 5) the protections required by sublessees from defaults under the ground lease.

The development ground-lease structure is a flexible tool for a quasi-joint venture relationship between a public or private landowner and a developer. The potential economic benefits to both parties can lead to acceptable allocation of risk for new development opportunities.

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