

Outside Counsel

Expert Analysis

Taking the Sting Out of Land Prices: Development on a Ground Lease

As the New York real estate market continues its recovery, land prices have attained record heights. While the price of development may vary from neighborhood to neighborhood, and even from block to block, land prices in Manhattan's most gilded precincts approach \$1,000 per square foot. Even outside Midtown's "Billionaire's Row," land prices in established Manhattan and Brooklyn neighborhoods routinely surpass \$500 per square foot.

These eye-watering numbers have dramatically altered the development landscape. While New York's rents are the highest in the nation, they aren't high enough, taking account of land prices, to justify rental development. Even condominium sale prices of \$1,500 a foot—only recently considered more than respectable—fail to make the grade, as escalating land costs erode profit margins. Predictably, developers have stampeded into the luxury market, while rental housing and modestly priced for-sale construction have languished.

The trend is ominous. A real estate industry tied solely to the wealthy is at risk of alienating its natural constituents. For most New Yorkers, the upper echelons of the industry inhabit a different planet, where concerns about rent and mortgage payments are considered quaint. The industry is also dangerously reliant on a small class of the global rich, whose appetite for New York real estate may not always be so voracious. In short, it may be time to reevaluate the current development paradigm. Properly structured ground leases may be part of the answer.

The Ground Lease

A ground lease has several defining traits, many of which are more typical of outright, fee

By
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ownership than ordinary leasehold tenure. A ground lease term is typically long, ranging from 25 to 150 years (if not longer). A ground lease customarily affords the lessee wide latitude in demolishing, redeveloping and subleasing any improvements located on the land. A ground lessee is further "triple-net," allocating responsibility for all real estate taxes, insurance premiums, legal compliance costs and other expenses associated with the land to the ground lessee. Finally, a ground lessee may mortgage its leasehold interest, and its mortgagee may avail itself of mortgagee protections set forth in the ground lease, such as notice and cure rights in the event of a lessee default, and the right to a new lease upon the then-executory terms of the ground lease, upon any termination of the ground lease by reason of the tenant's default.

Ground Lessor's Perspective

Before discussing the attractiveness of a ground lease for a developer, it is important to understand its appeal to a landowner. At today's high prices, why not sell? For many owners, this logic is compelling. But, for three classes of landowners—families, not-for-profits and the city itself—the benefits of a ground lease may outweigh those of a sale.

The Family Owner. While New York has become a magnet for international real estate investment, the industry is still intensely local. Some of the most desirable parcels in the city remain in the hands of families whose title may date back generations. These families, however,

usually lack the capacity to redevelop their land on their own.

While the temptation to take the money and run may be great, there are countervailing forces at play. First, after accounting for transaction costs (including transfer taxes and brokerage commissions), which may exceed 7 percent of gross sales proceeds, and income tax, which soaks up another 30 percent of these proceeds (assuming a zero basis), a sale may lose some of its appeal. Second, some families have sentimental attachments to New York City real estate. After all, who can put a price on owning a piece of the capital of the world, especially if it's been owned by the family for generations?

A ground lease, in addition to offering lessors the psychic benefit of continued ownership of the land, reduces transaction costs and income tax. First, the big ticket transfer tax item—city transfer tax of 2.625 percent—does not apply, as the city does not deem the transfer of a leasehold estate, regardless of the term, a transfer of real estate. The state does (if the term exceeds 49 years or the lease contains an option to purchase), but state transfer tax is a manageable .04 percent of the present value of the rents payable during the term. And while rents under the ground lease would be taxed at the ordinary income tax rate, the gains-tax levy payable upon a sale would be entirely avoided.

Not-for-Profit Institutions. Not-for-profit institutions—educational, religious, charitable and philanthropic—comprise another class of likely ground lessors. These institutions, while usually cash-strapped, own some of the city's most coveted real estate. But they can't easily sell it. They must often contend with charter documents and deed restrictions that circumscribe the disposition of real estate. They must also obtain the approval of the New York State Supreme Court to any land disposition. This approval is granted, or denied, based upon the recommendation of the Charities Bureau of the New York State Attorney General's Office.¹ The

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office, in evaluating a proposed sale, scrutinizes the charter documents and the economic terms of the deal to ensure that the transaction does not contravene the institution's mission.

A ground lease offers a way around these restrictions. Charter or deed restrictions may only prohibit transfer of fee title, leaving the door open to a ground lease. And even if the charter or deed restricts the land to the original, institutional use, the text may be expansive enough to encompass profit-making uses (including residential and retail use by a ground lessee) which support the institution's mission. And while a ground lease would usually require court approval, the Attorney General would likely recommend such approval, if the institution demonstrates that the lease would generate rent that would contribute to its viability.

A savvy institution could also leverage a ground lease into additional facilities. A synagogue could ground lease its land for redevelopment, provided that, upon completion, the ground lessor sublease a portion of the new building, at a preferential rent, to the synagogue for use as a sanctuary.

Even if a not-for-profit could freely dispose of its land, its principals may not wish to do so. They may prefer the long-term annuity provided by a ground lease to a one-shot cash infusion that could one day be squandered by an improvident board.

The City of New York. New York's most important ground lessor is likely to be the city itself. To bolster the finances of the Housing Authority, the Bloomberg administration has proposed ground leasing underutilized NYCHA (New York City Housing Authority) plots (such as parking lots) to developers. While this proposal has met with resistance from tenants and the City Council, it is likely to receive a sympathetic hearing from the de Blasio administration, provided that any redevelopment incorporate a significant affordable component.

The Developer's Perspective

While a prospective ground lessor has many reasons to consider a ground lease, a developer has only one: money. Simply put, a ground lease can take the sting out of today's land prices and render feasible transactions that otherwise wouldn't "pencil out." Take, for example, a prospective rental development site consisting of 100,000 square feet of development rights. Assuming a development rights price of \$500 per square foot, the land price would equal \$50 million. Even if a developer can finance the acquisition and construction of the building upon advantageous terms, the hard and soft costs of construction, coupled with operating costs, might

require rental assumptions which are not yet warranted by the market.

But if the transaction were structured as a ground lease, the land value could, for example, be paid in two tranches, the first being a "key money" payment of \$5 million, the second being annual payments of \$1.5 million, subject to adjustment by some fixed percentage, or the consumer price index, every five years. The developer could seek financing to cover not just the hard and soft costs of construction, but also the initial "key money" payment and ground rent due prior to completion of the construction and initial lease-up of the building.

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Upon completion and lease-up, the developer could refinance the building with a permanent loan (with a lower interest rate). If the developer has attained its base case rental targets, the project's rents would suffice to pay ground rent, debt service and other expenses, and yield a healthy profit.

Cooperative Housing

A ground lease may also permit developers to build and market for-sale units to New Yorkers who, while comfortable, are priced out of today's market. By enabling a developer to defer at least a portion of the land price to periods after unit sales, a ground lease takes pressure off the "base case" pricing a developer needs to obtain, if it is to earn a modest profit after payment of land costs and the hard and soft costs of construction. A ground lease also offers flexibility to unit purchasers, permitting them to "amortize" land costs over the term of the ground lease (by incorporation of ground rent in monthly maintenance payments), rather than pay the entire land cost up front as part of the purchase price. This is an option that some cash-strapped buyers may find attractive.

For-sale housing on a ground lease, however, poses unique challenges. As noted above, New York law does not accommodate leasehold condominiums.² Thus, the preferred means of apartment ownership—a condominium—is

not available. Rather, units must be marketed as cooperative apartments. Nevertheless, the bylaws of the cooperative could afford purchasers rights typically afforded to owners of condominium units, such as the right freely to sell or sublease apartments (subject to a right of first refusal in favor of the board), and to finance their units without restriction. In addition, higher-than-average monthly maintenance fees necessitated by the payment of ground rent could depress unit prices. But pricing is an art, not a science, and none of these obstacles need prove fatal. Furthermore, the offering plan should exhaustively disclose the terms of the ground lease, so no unit purchasers could later claim that they were not properly apprised of the structure of the development.

A developer must also give appropriate weight to the term of the ground lease. New York purchasers, unlike their London counterparts, are unaccustomed to leasehold tenure and likely will resist any term that falls short of the symbolic century mark. Rent should also be fixed during the entire term of the ground lease, so that purchasers can quantify the building's rent obligation and be spared the prospect of facing impossible-to-ascertain "fair market rent" increases at a later date.

A developer must also ensure that the ground lease is adapted to a cooperative housing development. For example, the lease must afford the developer the right, upon the substantial completion of the building, to assign the lease to a cooperative housing corporation. The ground lease should further compel the ground lessor in connection with any applications for tax abatements or other incentives. This cooperation may entail subordinating the ground lease to an agreement with the city to incorporate affordable housing within the redeveloped building.

Conclusion

As demonstrated above, a properly structured ground lease offers benefits to both landowners and developers. It might even make it possible to develop homes for New Yorkers of modest means. In doing so, developers could do well by doing good. And the city would be the better for it.

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1. Certain institutions, such as the Roman Catholic and Episcopal churches, are exempt from Attorney General review.

2. An exception to this rule is leasehold condominiums of state- or city-owned land, which are permitted.