Community and Economic Development in North Carolina and Beyond Blog: On Borrowed Ground: A Ground Lease Primer – Part 2

By CED Program Interns & Students

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In Part 1 of this series, the CED blog explored some of the basics of entering into a ground lease. Part 2 will explore on of the more complex aspects of the ground lease structure – the 'reappraisal'. Additionally, we will explore financing issues, as well as how property sales are reconciled with ground leases.

Reset – 'Reappraisal'

Generally, the ground lease is reappraised after a period of 10-20 years at the option of the lessee or property owner. The reappraisal can occur via an updated market value of the land, and therefore, increased cash flow at the same rental rate. Or, the rental rate can be reset to reflect market conditions, or the parties can agree to a predetermined payment increase. Terms regarding the reappraisal process are determined in the initial ground lease contract.

The reappraisal process is among the most contentious points of the ground lease lifespan since the goals of both parties collide: obtaining fair value and steady income versus making project financing and rent untenable. The property owner would likely have his/her cash flow value reduced overtime due to inflation, and land values may have appreciated during the initial term of the lease. As a result, the property owner may not be receiving 'fair market value' ground rent at the point in time of the ground lease reappraisal.

However, a reset of the ground lease rent and appraisal may imperil the lessee and financing for the building and improvements. A substantial increase in ground rent may alter the financing structure of the property: less income would be generated since more would be designated for ground rent. Ambiguous terms for how a ground lease is structured, and the basis for renegotiation, must be clearly delineated before the ground lease is signed because a lender would not want to be exposed to unpredictable rent payments.

Additionally, the basis for the reappraisal is a point of contention: the property could be valued based on the present-day highest-and-best use, or the existing use (that of the current lessee engaged in the negotiation).

Financing

Given that the developer does not own the property, a lender has to rely upon different terms in order to finance development and a permanent loan since the property may not be outright pledge as collateral. Lending ultimately depends upon whether the property owner subordinates or unsubordinates his/her property to the lender's loan.

In the subordinated instance, the property owner 'subordinates' the interest in his/her property to that of the mortgage loan. If the lessee were to default, then the lender would be able to take possession of the owner's property, and the terms of the ground lease would be removed. In the unsubordinated instance, the lessee obtains a mortgage leasehold, meaning that the property owner is not subjected to the lender's terms. If a default were to occur, the lender would assume the lessee's position as the owner of the building and improvements, and would be obligated to pay rent to the property owner under the ground lease terms.

Despite the clear advantages of a leasehold mortgage for the property owner, he/she may elect to enter into a subordinated agreement. The property would not offer any tangible income to the owner if the lessee does not obtain financing, especially if the property has high income potential. Despite the risk of losing the property, the owner may seek accommodative terms from the lessee, such as increased fees and payments and greater property owner control over the development project.   The absence of property collateral via a leasehold mortgage still allows the development to be financeable. Lenders will command higher loan rates and additional fees, though some lenders do not permit leasehold financing.

Sale

The sale, or assignment, of the building and improvements subjected to the ground lease are permitted or else the developer likely would not have undertaken the project. Any terms or process regarding the assignment should be included in the initial ground lease agreement. Based upon the terms of the lease, the property owner may have to agree to any transaction or approve the purchaser, although this is not universal. However, the potential purchaser must be compliant with the ground lease terms, but could engage the property owner on modifying terms of the lease. As noted earlier, much depends upon how a sale process is outlined in the initial agreement.

Conclusion

Ground leases can be relatively complex, time intensive, and costly to negotiate. Professionals within law firms and financial institutions likely specialize in ground lease issues, and are best suited to handle the more complex aspects of such transactions.

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