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Subject: Ground Lease Background Information

When an owner makes a long-term lease of land only, the lessee is said to have obtained a ground lease. Also called a land lease, a ground lease is commonly for a term of 50 to 99 years. Specific circumstances and the negotiations between the lessor and lessee significantly determine the make-up and contents of a ground lease instrument, but there are several elements that are typically present. In most cases, the lessee pays all expenses of the real property such as property taxes, insurance, maintenance and financing costs. The lease also will likely include provisions regarding any improvements made to the property.

Advantages and Disadvantages

There are several advantages that may motivate a prospective developer or tenant to seek a ground lease rather than a different form of ownership. First, the price of the property should be less than the purchase price of similar properties because the land is not being bought. Second, initial development costs should be drastically reduced, especially during the construction period. With a ground lease, the monthly expenses are fixed at the cost of the rent payment. Finally, a ground lease may be the only method to attain a piece of property. The developer may be dealing with a party, such as a City or non-profit entity, that generally is not disposed to or even permitted to sell the land.

Certain disadvantages tag along with ground leases that otherwise would not be incurred; the importance of successful negotiations is evidenced here. The shorter the ground lease term, the more difficult it may be to obtain financing. If the lessee was not successful in negotiating the terms and restrictions of the agreement, the lessee may have less flexibility in the development and operation of the property because of the landowner's control.

A ground lease is a way for a property owner to maintain ownership of the property while allowing long term development to occur. The ground lease agreement allows the property owner to maintain control of aspects of the development such as:

- Use of the property
- Type of structure/development

- Future transfer of the structure(s) to other tenants or owners
- Long term increase in property values.
- Right to require maintenance
- First right of refusal if/when the property is placed on the market
- Rights to act to forestall a mortgage default.

Who Uses a Ground Lease?

A ground lease is most often used in the following situations: (1) when the property is leased to a developer who subsequently will make multiple subsidiary leases; (2) when a governmental body, e.g., a town or county, clears land under an urban renewal program and leases the cleared land to a developer; (3) when a non-profit entity, such as a church or charity, cannot sell the property and leases the land; (4) in sale and leaseback transactions, which are a form of financing; and (5) for estate planning purposes.

Conclusion

The character of a ground lease varies depending on the needs and negotiations of the parties to the lease agreement. An example may involve a plot of land upon which there currently is no structure and the lessee intends to build one and lease space back to the lessor-owner. In this agreement, the lessor has a more active involvement with the lessee because instead of simply receiving payment on the leased land, the lessor has a substantial interest in the design planning of the building as well as in the future users or occupants of the building. The instrument would need to be drafted in a way to stipulate the extent of influence that the lessor would have on the tenant's development plans.

Ground leases provide a long term and often less costly alternative to ownership; however, the extent of the benefits directly stems from well-planned and well-executed negotiations between all of the parties involved. One of the major benefits of a ground lease is its flexibility in meeting the needs and requirements of each leasing situation. Just as in a mortgage for a fee interest, the interests of leasehold lenders must be taken into consideration in the planning and drafting of the lease instrument. The tenant enters into a long-term relationship with better security and knowledge about the status of the property. and the lender has a large portion of the background research for its financing decision made without additional expense and hassle.

Illustrative Example

In the specific case of "The Hill Property", the City is considering the possible development of "entry level" priced housing. For such a scenario, the following specific issues/thoughts/characteristics of the deal/relationship would be applicable:



- The City could facilitate construction of housing;
- The ground lease arrangement could be with a single developer (a not for profit corporation could serve as the developer) or with each individual homeowner;
- The arrangement could be for the entire development or for selected units. Other units would be sold at market rate by the selected developer/builder.
- The dwelling units are sold to owner/occupants through conventional real estate transaction, but the land is only leased. The period of the lease could be for 99 years or more.
- An HOA would have to be established for maintenance of common elements and basic property maintenance tasks.

Benefits for the home buyer in the ground lease relationship include:

- Homeowner right to privacy
- Exclusive use of the property and right to sell
- Shared Equity agreement allows some profit to be realized from a sale while keeping the property value from escalating in a rising market