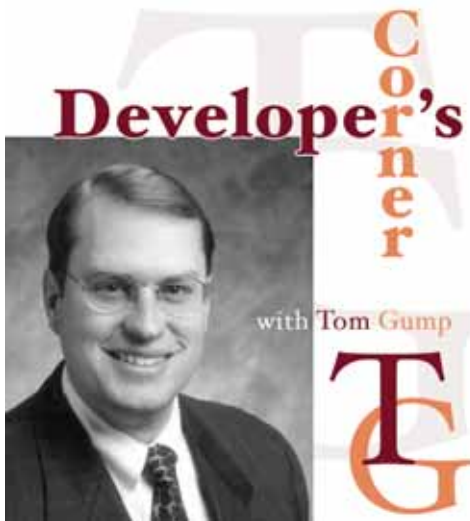


A creative tool in the current economy



by Audra Williams and Tom Gump

At one time, ground leases generally looked the same. A typical ground lease had a 99-year term and gave the tenant free reign over the property with all of the benefits and burdens of ownership. This is no longer the case. Not only are ground leases becoming more common for a wider variety of uses, but currently there is not a "typical" ground lease in the industry. As the credit markets struggle and real estate values remain depressed, the nature of ground leasing has evolved.

Common characteristics

Although ground leases come in far more shapes and sizes now than in the past, there are characteristics that are common to many of them. In order to realize the value of the improvements, most ground tenants insist on a term

longer than typically seen in leases for space. It is common to see terms of 10, 20 or 30 years for ground leases, depending on the end use of the property. Longer durations benefit the landlord, ensuring a steady income stream from the property.

Tenants also benefit from longer terms; in fact, the tenant's lender may dictate a minimum duration. Suppose the lender is taking a leasehold mortgage or a collateral assignment of the lease as security for financing the construction on the property. The lender needs to have assurance that it will be able to operate the property or sell the lease while the property still has enough value to allow a lender to recoup its investment.

Often, at the commencement of a ground lease, the lease is for raw land, and the tenant constructs any improvements. Title to the improvements remained severed from the title to the underlying premises during the term of the lease, and the improvements are then surrendered to the landlord at the expiration of the lease. In this way, a ground lease can be used as a valuable financing vehicle. Tenants avoid the cost of land acquisition, and landlords enjoy an income stream from the property while retaining control over it. It is imperative, however, that a ground lease be distinguishable from a mortgage in form and in function to avoid the consequences of the lease being deemed an equitable mortgage.

When are ground leases appropriate?

Ground leases are a good alternative to a sale when market conditions make it undesirable to sell or purchase property. We are all ruefully aware that land

values are currently low. Whether this is due to a bubble bursting or not, there is no doubt that values will eventually rise. A ground lease offers a means of deriving income from the property while the owner waits for the market to recover.

A local example can be found in our ex-urban communities. Now that development has slowed or stalled beyond the third-ring suburbs, parcels once considered critical to future development have lost much of their market value. Ground leases create an opportunity for those landowners to realize an income stream from the property while holding title in anticipation of increased future value. This is not to say that finding a tenant is an easy task, but at least the landowner is not risking the loss that may result from a sale.

Under different circumstances, property values may be considered artificially inflated, making acquisition of property undesirable. Potential developers may find a purchase cost-prohibitive, but ground leasing creates an opportunity to proceed with a project while avoiding the seemingly excessive cost of fee ownership. Landowners may prefer a sale in such a situation, but the steady income stream, as well as tax and other economic considerations, can make a ground lease an appealing option.

Ground leases are also useful in the context of alternative energy development. In Minnesota, leases are used by wind developers as a means of acquiring a temporary interest in land, thus allowing them to build a wind farm without taking title or committing the planned use to an indefinite term.

These leases are generally short enough to allow the utility to adapt to future technologies, but the leases should include extension options as well. We have already seen wind technology advance by leaps and bounds, and it is anticipated that innovations will continue. It would be foolish to maintain fields of archaic turbines when more efficient machines are common and available five, 10 or 20 years from now.

Issues in ground leasing

Despite the many advantages of ground leasing, these transactions may present challenges. Since they are often used when property values are at one extreme or the other, valuation can be difficult. Lender involvement can also present a challenge if the lender is accustomed to dealing with fee ownership.

Ground tenants, though receiving a bargain on land "acquisition" costs, are ill advised to perform due diligence on the cheap. Entering into a ground lease arguably warrants more extensive diligence; the condition of title is critical

to a long-term tenant about to make substantial investment into the property, and the financial condition of the landlord should be investigated and understood. A ground landlord's bankruptcy can yield disastrous results for a ground tenant. For this reason, bankruptcy counsel, as well as real estate counsel, should be involved in drafting and negotiating the document.

A final major issue in ground leasing is the surrender of the property. In ground leases, a tenant's maintenance obligation is magnified by the fact that the tenant will surrender the improvements to the landlord at the expiration of the term. Thus, the tenant has little incentive to make capital improvements as the term nears conclusion. Savvy landlords can negotiate around these problems at the commencement of the lease, creating escrow accounts and rights of entry for maintenance and repair during the last years of the term. Failure to anticipate such issues and address them in the document could result in tenant malaise, which results in an ultimate cost of repair far in excess of routine maintenance costs.

All told, ground leases are a creative and useful tool in our current economy. Both landowners and potential users can benefit from a well-structured ground lease. There are pitfalls, however, and any transaction must be carefully analyzed and documented to ultimately succeed.

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