
Public-Private Development: Aligning Interests Through a Ground Lease.

To facilitate real estate development projects, the public sector often seeks to structure its public-private transactions through a ground lease. For the public sector, a ground lease possesses a number of important features, including: (i) an enforceable mechanism to structure both the development and operational relationship with its private sector partner; (ii) the opportunity to realize longer-term economic value in the property once improved; and (iii) the means to ensure that particular public objectives are achieved. For the private sector, while a ground lease presents challenges that must be addressed, the structure allows for a number of benefits, including: (i) the opportunity to develop a project without carrying a significant upfront acquisition cost for the land; (ii) a means to access tax benefits; and (iii) a flexible structure that can adapt as a project moves from the construction phase to the operational phase.

Given the parties' varying objectives and the long-term nature of the relationship, public-private ground lease negotiations are complex and lengthy in nature. These negotiations typically focus on the following key provisions:

- rent, revenue participation and resets; tax benefits;
- capital work and public sector oversight; use and operations;
- term and purchase option;
- transfer restrictions;
- casualty events; and
- reporting requirements and audit rights.

By undertaking a ground lease transaction with a sound understanding of each party's key objectives and by using the negotiation process to align the parties' interests, the ground lease provides a means to optimally allocate risks and benefits to each of the parties, which can lead to transformative real estate development projects.

Rent, Revenue Participation, and Resets: Maximizing Public Sector Long-term Value

Although the public sector often has significant nonmonetary objectives when negotiating a ground lease, the public sector also seeks to maximize the value of its real estate interest. Since governmental entities are not equipped to enter into formal joint venture agreements with developers, a ground lease represents a suitable alternative form to memorialize these arrangements. Consequentially, the public sec-tor attempts to negotiate a rental stream that in the aggregate reflects its contribution to the project. Typically, negotiation of the rent provisions focus on: (i) a base rent that escalates over time; (ii) a participation component; and (iii) periodic resets. By structuring these revenue streams in a manner that provides the private sector with a level of certainty regarding its annual payments while also offering the public sector the opportunity to participate in the project's success, the parties can align their respective interests.

Base Rent

While base rents can vary, the parties tend to negotiate a rent that is between five percent and seven percent of the agreed-upon value of the land subject to the ground lease. The agreed-upon value presents the real challenge in this negotiation. While the public sector may anchor itself to an appraisal based on highest and best use, the developer wants to make sure that the appraisal accounts for any development limitations set by the lease. For example, even though an all residential project may represent highest and best use, if the developer is limited in the amount of residential space allowed in the project, the appraisal should account for such limitation.

Escalations

The escalation of ground rent payments represents a significant concern for both parties. Often times, the public sector negotiates to tie the escalations to an objective mea-sure such as the Consumer Price Index ("CPI"). The challenge with using CPI though is that land values and CPI increases do not necessarily correlate. In a strong real estate market, land values may rise significantly while CPI remains relatively flat. Over the past few years in New York City, for example, land prices have increased significantly while inflation has remained low. Although the relative steady nature of CPI in recent history would appear to benefit a developer, a developer often looks to have even greater certainty with respect to what its future rental payment stream will be given that ground leases can extend for upwards of 99 years. As a result, a developer either seeks to have a fixed annual percentage rental increase or looks to tie the increase to CPI subject to a cap on annual increases. Within this basic framework, there are numerous variations. For example, instead of increasing annually, the parties may agree to ground rent payments that step up periodically (e.g., once every three years).

Given that periodic increases may not appropriately reflect changes in property values, periodic reset provisions often are negotiated in ground leases. These provisions require that an appraiser undertake an appraisal, and as noted above in the context of base rent, the parties' negotiations focus on the scope of the appraisal. While the public sector tends to propose a highest and best use scope, the developer again needs to negotiate to ensure the valuation takes into account the limitations established by the ground lease as well as the age of the facility then on the property. The developer wants to ensure the valuation is of what the property is and not of what the property could be.

Participation

Since in many respects the ground lease acts like the public sector version of a joint venture, a participation rent provides the public sector with the opportunity to realize additional value for its property contribution, particularly in the event of a highly successful project. Given the unknowns associated with the project at the time the parties negotiate the participation provision, these negotiations can be particularly challenging. In addition to the percentage itself, the parties must agree on the base number to use in the calculation. While the public sector prefers to have the participation calculated off a gross revenue number, the developer understandably is resistant to such a calculation because a net number is more reflective of the true success of the project. For the public sector, a net number presents a challenge because the public sector is not well positioned to assess the appropriateness of certain expenses incorporated into the calculation. For instance, the developer may allocate certain overhead costs to the property's operation, which can be difficult for the public sector to verify. Consequentially, the public sector needs to have appropriate audit rights to confirm the participation payments.

As with rent escalations, there are numerous variations to the rent participation framework. For example, the parties typically discuss whether to use a tiered structure for the participation. In this instance, the parties agree to adjust the percentage rent applied to revenues as those revenues grow in a given year. To the extent a project is more successful, the public sector receives compensation for a greater share of that success.

While the parties may see each component of the rent stream in a binary light, when viewed in terms of a structure that over time (i) provides the developer with some level of certainty regarding payments, (ii) fairly compensates the public sector for its initial investment through the contribution of its property and (iii) further benefits the public sector party in a manner that tracks the success of the project, the rent stream represents one significant tool to align the interests of the two parties.

Tax Benefits: Other Forms of Public Sector "Investment"

Although tax benefits represent another deal term viewed in a zero-sum fashion, when war-ranted these benefits are an additional form of public sector investment in a project. This is particularly true given that the public sector is increasingly less likely to make direct capital contributions as budgets tighten. Through the targeted use of tax benefit tools, the parties can work together to develop an optimal plan that further ensures the project comes to fruition.

Tax Exemptions

Maximizing the long-term value of its property represents one public sector objective, but the ground lease also is often the means through which the public sector can further invest in the project by providing a real estate tax exemption. Typically, property owned by a public sector entity is not subject to real estate tax under applicable state law. For example, Section 404 of the New York Real Property Tax Law exempts real property owned by the State of New York from real estate taxes while Section 406 exempts real property owned by the City of New York from real estate taxes. Therefore, by having a public sector entity retain the fee interest, the entity can make an-other longer-term investment in the project through the real estate tax exemption.

If the parties have not agreed to preserve the real estate tax exemption, the public sec-tor typically negotiates a provision requiring that the developer make payments-in-lieu of taxes, or PILOTs, which the parties can structure to mirror the amount that the developer would otherwise pay annually or can structure as a fixed-payment schedule. In addition to real estate taxes, in certain instances the public sector can provide other tax benefits through the ground lease. For example, in New York City, the public sector may provide a sales tax exemption through the ground lease.

Tax-Exempt Financing

In addition to facilitating a tax exemption, ground leases commonly are used in tax-exempt financing transactions, which represents yet another manner in which the public sector can contribute to a project. The parties can structure this financing in a few different ways. The public sector and developer may undertake a tax-exempt bond financing in which PILOT payments made by the developer act as the source of repayment of the bonds. Per Internal Revenue Service regulations, the PILOTs must be "commensurate with the amount imposed by a statute for a generally applicable tax".

Another tax-exempt financing structure used for development projects involves 501(c)(3) bonds. This particular structure has become more prevalent in the student housing area as public universities turn to private developers to build new student housing. In this type of public-private partnership, the university ground leases its property to a not-for-profit conduit issuer who in turn issues 501(c)(3) bonds to finance the student housing development. The not-for-profit tenant also enters into development and management agreements with a private sector partner who proceeds to develop and operate the project. The ground lease has a term that extends for a period sufficiently beyond the term of the bonds. At the end of the lease term, the improved property returns to the university. Through this structure, the university has the ability to not only access tax-exempt financing but also to work with a developer with expertise in student housing development without fore-going its fee interest in a property.

Construction and Public Sector Oversight: Ensuring the Project Comes to Fruition

With respect to the project's construction period, the parties need to focus on establishing a process that provides the public sector with sufficient comfort that construction progresses on schedule while at the same time not limiting the developer's ability to use its expertise to efficiently manage construction. The extensive negotiations that typically take place over the level of the public sector entity's involvement in monitoring a project's construction phase is particular to the public-private context. When viewed in the context of the ground lease being analogous to the public sector's version of a joint venture, this focus makes a good deal of sense. The public sec-tor usually undertakes an extensive diligence process to ensure that its private sector partner is proposing a feasible project and that the developer has the resources and ability to successfully deliver the project on time and on budget. The resulting ground lease safeguards relating to project delivery are particularly critical to the public sector because all too often the public sector has experienced situations in which its property winds up being saddled with a ground lease and where the developer can-not deliver a project.

As noted above, the public sector often makes significant contributions to the development project through its land contribution as well as tax benefits and should negotiate the construction period provisions as a joint venture partner would. In fact, the public sec-tor may structure the transaction so that the ground lease only becomes effective upon the developer fulfilling certain conditions, including a final set of plans and specifications, a fully negotiated construction contract and construction financing in place. The parties may negotiate an agreement to lease or development agreement to govern the period prior to the ground lease becoming effective. The public sector also seeks to have the developer provide a completion guaranty and/or provide security in the event of default where the developer leaves the property with a partially completed project that the public sector must remove. As is the case in a traditional construction financing, a key item with respect to the completion guaranty is the identity of party who will provide the guaranty. Since the developer likely has formed a special purpose entity with no other assets to act as tenant under the ground lease, the public sector needs to ensure the sponsor entity steps in to provide the guaranty.

To make sure construction proceeds in accordance with the final project budget and schedule, the public sector wants to negotiate into the ground lease rights to monitor construction through regular updates and inspections. For the developer, it seeks to make certain that these rights do not delay the project's development. During negotiations, the parties will likely discuss the appropriateness of having a deemed approval provision with respect to items for which the public sec-tor has an approval right. While a reasonable request, the public sector must make sure it is equipped to respond in a timely fashion.

Although the public sector strives for certainty in this process, there often is significant uncertainty associated with development projects. Hence, a developer looks to build enough flexibility into ground lease provisions so that the developer does not risk an event of default if and when construction does not proceed according to plan. This is particularly important because the ground lease will need to include typical provisions that make it financeable, including provisions regarding recognized leasehold mortgagees, notice and cure rights for mortgagees and new lease rights in the case of a termination. Given that the construction lender shares the public sec-tor entity's interest in project certainty, the public sector may take comfort in the construction lender having the necessary rights and protections typical in a construction loan provided by an institutional lender. To ensure that the lending party is an institutional-type lender with sound underwriting standards and the ability to insist on customary lender protective provisions in the loan, the public sector typically negotiates recognized mortgagee provisions requiring the lenders to be of a certain financial standing.

Not surprisingly, one of the biggest points of negotiation in the construction context is the completion date. Obviously, a developer seeks to have as much cushion as possible on this term. Additionally, its construction lender wants to make sure that there is sufficient time so that in the event the lender must foreclose on the developer's interest and bring in a replacement developer there is time for this to occur without facing a default and potential termination of the ground lease. Since the completion date may trigger the commencement of rent payments, the public sector may have a basis for negotiating a liquidated damages provision for lengthy delays in completion. As the delay grows, the public sector has grounds to expect a higher damage payment.

Use and Operations: Ensuring Success is Not Fleeting

Through the combination of a prescriptive use provision with defined parameters for granting relief, the parties can establish a structure that protects the public sector's interest in seeing its property activated in a particular way while also allowing the developer to make adjustments if market conditions warrant. Since the public sector often enters into a ground lease expecting a particular end use that satisfies certain public objectives, the public sector typically negotiates prescriptive use and operation provisions that go beyond standard provisions prohibiting noxious uses. For example in a retail development, the use provisions may specify the type and quality of tenants as well as minimum operating hours. The public sector typically also includes limitations on "going dark" to prevent extended periods of inactivity on the property. Collectively, these use provisions are particularly important because job creation often is a key project objective. Furthermore, in the event that the public sector expects to derive a significant component of the project's economic value from percentage rent, the public sector wants to ensure the property remains active.

In addition to the economic component, the use provisions may also act as another overlay of zoning with certain uses being prescribed for different components of the project. For example, the use provisions may prescribe streetscape retail on the ground level with commercial office space residing on upper level floors. The public sector may also negotiate to have a portion of the developed project retained for its own use or the use of groups in the surrounding community. As a result, the public sector seeks to ensure that the various uses are compatible.

While the public sector, as is the case during construction, seeks certainty, the developer again seeks the flexibility to allow the project to adapt over time. The developer may needs this flexibility because the market for the project does not materialize as expected or be-cause market preferences change over time. The developer typically makes the case that it is incentivized to maximize activity on the property since profit maximization is its primary motivation. To the extent one use does not maximize profits, the developer will ultimately choose another use that does over having the property remain dark.

To address these competing concerns and to implement a structure that provides some level of flexibility, the parties can agree to include a set of parameters, which if met would provide the developer with a basis to request relief from the prescriptive use provision. For example, in the event the ground lease re-quires a particular type of tenant as occupant for a minimum amount of space, the agreement could provide that if the developer can demonstrate it has diligently marketed the space for a minimum period of time but has not attracted a tenant the developer would have the ability to offer the space to a wider range of tenants.

Term and Purchase Option: Determining How Long is Long-Term Part I

Given the significant investment that a developer makes to develop a project, a ground lease tends to be a minimum of 25 years and often runs 49 years or more. Generally, a lease of 25 years does not provide sufficient time to make a developer's investment of time and money worthwhile. It is not atypical to have a 49-year ground lease with tenant options extending the term to an aggregate of between 75 years and 99 years.

In the context of the ground lease term, negotiations tend to focus on whether or not the developer will have the option to purchase the property at some point during the term. While the public sector may want to preserve its reversionary interest in the property, if structured correctly, the public sector can realize the value of its property interest through the purchase option once the project has reached stabilization. As in the case of the base ground rent and rent reset calculation, the purchase option negotiation focuses on the scope for the appraisal that is typically undertaken to determine the developer's purchase price. The parties can look to the present value of the future rental payments to inform the discussion, but the fact that the public sector likely expects a portion of its return in the form of percentage rent means that the base rent stream does not fully reflect the value of the public sector's interest. While the parties can estimate future participation based on past experience, the public sector also must ensure that the valuation is not depressed because the developer opportunistically exercises the option at a low point in the market. As a result, the parties must work through a number of scenarios to appropriately address the potential issues raised by valuing the public sector's interest.

The developer's argument for a purchase option is stronger in the instance where the ground lease is simply undertaken to provide a tax benefit or facilitate a tax-exempt financing. In those instances, the parties can tie the purchase option to the point in time when the agreed-upon tax benefits have expired or when the tax-exempt financing has been repaid.

Transfer Restrictions: Determining How Long is Long-Term Part II

Although provisions restricting transfers apply to both the development stage and operations stage, the parties can craft these provisions to provide the public sector with the comfort of knowing that the developer will not exit before project completion and with knowing that over the long term a party with the necessary property management expertise will oversee its operations. Developers generally understand that the public sector is looking to the developer to deliver the project so the ground lease significantly limits the developer's ability to transfer its interest in the project during construction. While the developer needs sufficient flexibility to bring in additional equity partners, the public sector wants to ensure that the developer retains control over management of the project given the reliance on the developer's expertise. The public sector also wants to make sure the developer continues to have "skin in the game." As a result, during the construction phase, the ground lease may include a minimum equity stake for the developer as well as a requirement that the developer remain in control of the project.

Once the developer completes the project and the project reaches stabilization, the developer has a basis to negotiate less restrictive transfer provisions. The developer's business model may not focus on the continued management of a stabilized asset. As a result, provided that the developer has successfully delivered on its construction commitments, the ground lease may allow for less restrictive transfer provisions during the operational phase. For the public sector, the key component of a less restrictive provision is that a property manager with a sufficient level of expertise and quality manage the project moving forward. The parties may agree in advance on a group of entities from which to choose or may agree on a set of criteria, such as a certain amount of space under management, that a property manager would need to satisfy.

Casualty Event: To Restore or Not to Restore

Given the length of a ground lease's term, the parties need to address the potential that at some point a casualty occurs. By crafting provisions that take into account the extent of the damage and the timing of the event relative to the lease's remaining term, the ground lease can reflect the public sector's interest in having the project restored while not overly burdening the developer with an absolute restoration obligation. For the public sector, it seeks to ensure that the private sector party is carrying sufficient insurance so that proceeds cover restoration of the project. The public sector looks require that the developer restore the project to at least the same condition as prior to the casualty event. In contrast, the private sector party wants to preserve the flexibility to determine how best to proceed based on the extent of the damage and when during the term the casualty takes place. Typically, a developer agrees to the restoration requirement provided the extent of the damage caused by the casualty does not exceed an agreed-upon threshold amount. The parties may base this threshold amount on the value of the property or on the square footage of the property. For example, a developer may agree to restore provided the damage does not exceed 50 percent of the value of the property or instead 50 percent of the square footage of property. During the final years of the ground lease, neither party may have an interest in restoring the project given the project's age and the ground lease's remaining term. As a result, the parties typically agree to lower the material casualty threshold in the final years of term so that the developer's restoration requirement is limited to minor casualty events.

In the casualty provisions, the parties also need to account for the potential requirements of the developer's lender who will seek to control the use of any insurance proceeds in the event of a casualty. For the public sector, the lender's right does not present an issue provided the lender agrees to have the proceeds used first for restoration. Repayment of any loan amounts should occur only in the event that the developer has the right to terminate without restoring the property. In the event that a casualty triggers a termination of the ground lease and pay out of proceeds, the parties need to work through the waterfall for these proceeds. The developer will seek to have proceeds first paid to it for the value of the improvements while the public sector will seek to have at least a portion of the proceeds paid to it for the value of its land. This tension again leads to the parties seeking an appraisal to determine the relative value of their interests in the property.

Reporting and Auditing: Providing for Transparency

By incorporating transparency measures into the ground lease, the parties are more likely to receive the necessary buy-in from public stakeholders and are more likely to achieve their collective objective of developing a successful project. When negotiating a ground lease with the public sector, a developer needs to understand that the public sec-tor must ensure that a transparent process occurs both for its own interests and the interests of its constituents. Since the public sector entity undertaking the ground lease likely has reporting obligations to public bodies and the public at-large, the public sector typically includes a robust set of reporting obligations on the part of the developer as well as significant auditing rights. With respect to reporting, the public sector has an interest in ensuring the project delivers on the commitments made in the ground lease and any ancillary agreements. In an economic development project, for example, the public sector wants to receive updates with respect to the number and types of jobs being created as well as average wages being paid. The public sector may also require a local hiring effort as part of the project, which requires additional compliance monitoring.

It also is worth noting that as the public sec-tor increasingly becomes subject to stronger transparency measures, the public sector in turn must ensure that it receives the information necessary to keep constituents apprised of project developments and whether the project is delivering the benefits promised. To ensure that the public sector receives the in-formation that it needs in a format that it can readily digest, the parties should agree at the time of ground lease execution on the appropriate format for periodic reporting. Additionally, the public sector is likely subject to the oversight of other public sector parties, so audit rights represent an important provision to work through. For example, in New York City, the city comptroller's office conducts audits of city agencies so these agencies must have the means to respond by having an appropriate level of audit rights.

In addition to compliance and audit, the developer must report on the project's financial operation to the extent that a participation rent comprises a component of the rental stream. Since the public sector from time to time may disagree with the calculations used for participation rent, the public sector needs the ability to more closely review the books and records of the project to make sure the calculations are fair and accurate. This is particularly important when participation rents are based on net income figures. To the extent that general overhead costs, for example, are being allocated to the project, the public sector wants to ensure that these costs are appropriately attributable to the project.

Conclusion

Although ground lease negotiations present challenges for both private sector and public sector parties, the nature of the process can allow the parties to work through these challenges to develop an agreement that aligns their respective interests and optimally al-locates risk over the length of the ground lease. For the public sector, the ground lease acts as means to invest in a project through the contribution of its property and potentially other public sector support and allows for a level of protections for the public sector that appropriately reflects the stage in which the project exists. For the private sector, the ground lease is a means to receive that public sector support while at the same time providing flexibility over time to adapt the project and its role in the project within parameters agreed upon at the outset of the term. Taken together, the ground lease provides the basis for a structuring a mutually beneficial long-term relationship between the public and private sectors.

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The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.