How ground leases can help not-for-profits redevelop their properties, part 2 - by Patrick O’Sullivan

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Patrick O’Sullivan

For not-for-profits where an opportunity exists to monetize their property’s value to help finance the construction of a new facility, a ground lease offers significant flexibility for structuring a development transaction. With that flexibility comes a complex set of negotiations in which the parties must engage over both transaction economics and the level of involvement of the not-for-profit throughout the development.

Navigating Economic Terms

Ground lease discussions are complex because the agreement provides the parties with multiple economic levers to pull. To begin, the parties need to come to terms on a base rent schedule. The options range from a prepayment of rents to closely mimic a sale price for the property to a more heavily weighted payment of rent near or at construction completion. One attractive feature of a ground lease to a developer is that the structure can represent a form of “seller financing” to the extent that the developer is not obligated to make a significant rent prepayment. Often, the parties land in between the two extremes since a not-for-profit wants to receive sufficient value upfront to help ensure the developer is motivated to proceed expeditiously with development while at the same time a developer is reluctant to fully prepay the rent given it is receiving a leasehold interest.

In addition, the not-for-profit may negotiate some form of participation interest. Since development projects involve some level of speculation, the base rent the not-for-profit receives may not ultimately reflect the value of its project contribution. A participation interest provides the not-for-profit with an opportunity to realize a portion of a development’s upside if the project performs better than anticipated particularly if market conditions at the time of project commencement are not fully reflective of the property’s value. Given the time development takes, the market at project completion may have moved significantly since project inception.

Oversight and Remedies

The not-for-profit's involvement in the development and its remedies for a developer's default represents a second area of focus in the negotiations. The not-for-profit retains its fee interest in the property, which represents an important protection in the case of a developer default. Given that the not-for-profit is particularly concerned with construction of its new facility in addition to its ground rent payments, the ground lease will typically provide the not-for-profit with review and approval rights of plans for its facility but not necessarily for the entire project. Additionally, the not-for-profit often will look to have the developer provide a completion guaranty, and the parties will need to work through whether the guaranty is with respect to its facility or the entire project.

While the ground lease provides the not-for-profit with a set of landlord remedies in the event of a developer default, the not-for-profit will need to agree to a set of provisions that make the ground lease "financeable." The required provisions, which are well established at this point, include:

Landlord recognition of a lender provided the lender meets a definition of an institutional lender;
Notice to the lender of defaults and a lender right to cure as well as an opportunity for the lender to proceed with foreclosure on the leasehold interest; and
A lender right to a new lease if the tenant terminates the lease through rejection in a bankruptcy.

Since the not-for-profit and lender will share an interest in having the developer successfully construct the project, the not-for-profit can take comfort in the safeguards instituted by the lender.

The complex negotiations undertaken by the parties can lead to a project in which the economics reflect the not-for-profit's contribution to the transaction and one where the not-for-profit has sufficient safeguards with respect to the development of its new facility. The next part of this three-part series will discuss structuring the long-term relationship the parties will have upon construction completion.

Patrick O'Sullivan is a partner in the Real Estate Department at Herrick, Feinstein, New York, N.Y.