

**"I OWN IT AND YOU DON'T" -**  
**WHY FEE OWNERS GROUND LEASE THEIR PROPERTIES**

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1. **INTRODUCTION.** Ground leases date from the earliest evolution of the common law of real estate. They represented in their earliest form a means to shift to the ground tenant all of the burdens and many of the risks of making the ground economically productive—essentially growing the crops or raising the farm animals. Times have changed but the essential nature of a ground lease has not. The owner of unencumbered fee simple title to a parcel of land must, of course, undertake some form of economic activity to make the land productive. In a modern urban setting, this can range from the simplest use, such as surface parking, to a sophisticated use, such as a mixed use, high-rise structure. Given appropriate land use regulations, capital and a viable market, the fee owner is free to make these choices and take the risks incumbent upon the choices made. The fee owner has, as it is said, the full bundle of ownership rights.

Some fee owners, for various reasons, including those discussed later in this article, do not wish to partake directly in such economically productive activity. Nevertheless, the fee owners wish to retain ownership of the fee and to reap a fair return from such ownership. To do this they must shift the right to possession of the land, and the direct right to exploit its use, to a third party. This is essentially what a ground lease does. The fee owner surrenders, with some very limited exceptions such as the right to inspect, its right to possession of the land for the term of the ground lease. By doing so, the fee owner also surrenders, again with some restrictions, its right to develop and then to operate the structures on the land for the term of the lease. The land tenant gains these rights. As is discussed in the other articles in this section dealing with specific provisions of ground leases, given the long term nature of ground leases, the exact balance between the transfer and retention of rights is critical to the success of the ground lease transaction between the leased fee owner and the ground lease tenant.

So why ground leases? "Because I own the ground and you don't" is a start but not the only reason. Except for areas that have historically been ground leased, with holdings of Grovenors Estate in the Mayfair area of London and the extensive ground

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leased estates of Hawaii being the prime examples, there are certainly a large number of reasons why a fee owner would elect a ground lease to the alternatives of sale or continued unencumbered ownership. Discussed below are four principal reasons for electing to use a ground lease.

**2. GOVERNMENTAL DEVELOPMENT.** Ground leases have been at the heart of many of the governmental redevelopment programs in urban America. The redevelopment of Times Square/42<sup>nd</sup> Street is a prime example of this. New York State and New York City joined together to create a complete redevelopment plan for this world famous area of New York City based upon a public-private partnership. The private sector has largely been responsible for the actual redevelopment activities, and the public sector has largely been responsible for delivering fully assembled sites, ready for development and with appropriate economic incentives. The governmental authorities condemned a significant portion of the properties along 42<sup>nd</sup> Street from Sixth Avenue (Avenue of the Americas) to Ninth Avenue and then leased sites to selected developers. A long-term ground lease was used in order to provide appropriate governmental incentives to the private sector developers and to retain certain governmental controls. The incentives included creating a special regime with respect to the real estate ad valorem taxes to which the properties would be subject and exempting the developers from sales taxes related to construction materials and tenant fit out; further tax relief based upon incremental employment; and other subsidies to the developers and tenants such as cheap (or less expensive) electric power from the New York State Power Authority. The level of real estate tax payments is regulated through a PILOT or Payment in Lieu of Taxes agreement. The ground lease technique not only permitted the City and State to negotiate individual subsidies with the developers and tenants but also provided the City and State with long-term controls over the sites. These controls included use and architectural controls, such as special requirements as to maintaining substantial neon signage throughout the area.

The lease terms average approximately 99 years and in most cases the leases are real ground leases with substantive covenants and default provisions. In cases where the developer reimbursed the land costs in full as part of the economic deal, the ground leases have "one dollar" purchase options. Where such costs were not reimbursed, the leases have purchase options at fixed or formula prices. Thus, in most cases, these ground leases are not mere vehicles for provision of government development subsidies but agreements with which the developer and prospective occupancy tenants, lenders and buyers must deal.

**3. FINANCING.** Financing, or, actually, the lack thereof, is another reason for the creation of ground leases. Because a ground lease avoids an upfront capital investment in the land and often has a rental rate that is more favorable than alternative financing rates (because of the senior nature of the obligation), ground leases can be an important part of the financial structure for a development deal. An example of this is the New York Palace Hotel, or as it was originally called, The Helmsley Palace Hotel. In the mid-70s, Harry Helmsley, a famous New York developer, approached the Archdiocese of New York about developing a site at Madison Avenue and 50<sup>th</sup> Street – directly across



the avenue from St. Patrick's Cathedral. A principal portion of the site was occupied by the Villard Houses, the landmarked mansion of former publisher of the New York Post – Henry Villard. This property had been the headquarters of the Archdiocese but had become too small and, due to the landmarking, had become a financial burden on the Archdiocese. Despite the weak real estate market at the time, Mr. Helmsley believed he could develop a luxury hotel on the site. Mr. Helmsley's development structures often involved highly leveraged tax deals. Thus, he had no particular interest in acquiring the land – a non-depreciable asset. After prolonged negotiations with New York City and the Landmarks Commission, an agreement among the Archdiocese, Mr. Helmsley and the Landmarks Commission was reached whereby Mr. Helmsley agreed to restore the exterior and significant portions of the interior of the Villard Houses in return for being able to develop more bulk on the site (through a special amendment to the New York City Zoning Resolution) than would otherwise be permitted. For its part, the Archdiocese granted Mr. Helmsley a long-term ground lease at a very favorable rent during the initial term, thus effectively sharing part of the cost of the restoration of the Villard Houses.

A similar structure was used again by Mr. Helmsley when he and his investment group acquired the Empire State Building. Ownership of the land and building were divided pursuant to a long-term ground lease to Prudential Insurance Company. The sale of the fee interest to Prudential produced greater proceeds at a lower cost than the mortgage financing options then available. The ground lease also permitted Mr. Helmsley to create a highly leveraged, tax-sheltered position for the private investors in the deal. An operating lease was created to put operating control of the Empire State Building into the hands of Mr. Helmsley and his operating partners.

This structure further highlights another reason for the creation of ground leases; that is, the very secure rental income stream created for the ground lessor can be attractive to various institutional investors, such as insurance companies and pension funds, which have long-tail liabilities or otherwise require such bond type income. As such ground leases typically have rent adjustment clauses, the institutional investor gains some degree of inflation protection as compared to long-term bonds. In addition, for truly long-term investors, the ultimate residual value of the property provides further value enhancement.

**4. FAMILY PLANNING.** For many years, the ground lease has been a favorite family planning asset for the wealthy. As ground leases are typically double net, if not triple net, leases, the leased fee is a relatively easy asset to manage. For the most part, the fee owner need only collect rent, check to see that taxes are paid and make sure insurance is in place. The ground tenant generally has complete operating responsibility for the land and improvements, including any capital improvements required by law or required just to maintain the improvements and the restoration following casualty. Thus, ground lease investments require very little management structure for the family members to support.



A ground lease is also a good asset for family or trust ownership because it is relatively easy to divide the income stream – the net rent. As noted, there are rarely significant expenses of ownership. As the number of family members entitled to receive a share of the net rental income increases, often a custodial bank account or a payment direction to the ground tenant is all that is required to provide for proper allocations of the net rent among the family members.

Moreover, leased fees provide meaningful financial leverage. Until a significant portion of the ground lease term has run, the ultimate residual value of the asset is often large compared to the value of the land as encumbered by the ground lease. Thus, the actual estate tax cost of preserving the ownership of the leased fee as it passes from generation to generation may be acceptable to a wealthy family. Appropriate estate tax planning may further reduce the interim tax costs. Upon lease expiration, the later generation can realize upon the full value of the unencumbered fee by releasing the property or through sale or other means then appropriate. For these reasons, leased fees are sound core assets to be passed through generations of ownership. The sites at 150 East 42<sup>nd</sup> Street and 425 Park Avenue, for example, have been owned by the same family for over 100 years. Each site is improved by a major commercial office building and thus carries a significant residual value.

An analogous situation may exist for institutions that hold valuable land sites, some of which represented the original location of the institution until it outgrew the site and, when relocating, could capture its long-term value through a ground lease. The University of Washington sites in downtown Seattle are one example of this. Another is the former Columbia University site in mid-town New York on which the main part of Rockefeller Center was constructed. That ground lease was sold in the mid-80s in a transaction where a REIT was created to provide Rockefeller Center's owners with approximately \$1.3 billion in financing. Another famous New York landmark—the Chrysler Building—is also a ground leased property with the fee owned by Cooper Union. The Chrysler Building is one of only two multi-tenanted commercial office buildings in New York City that is exempt from New York City real estate taxes—in this case because of a special state statute favoring Cooper Union. The ground rent collected by Cooper Union includes a tax equivalency payment based upon the real estate taxes that would be payable if the property were not exempt. As no other private buyer would enjoy a similar exemption, Cooper Union is the likely owner of the fee position for a long time.

**5. TAXES.** Many ground leases arise from situations where the fee owner held an investment property for a very long period of time. Then, due to changes in the market or gentrification of the area, the property became ripe for redevelopment, but a sale to a developer would generate a very large gain and thus substantial taxes. This is especially true if the fee owners have been successful in reducing estate taxes over time, as the corollary is that the successive generations have not benefited from full step-ups in basis. If the fee owner calculates the sales price that it would have to receive in order to obtain a net investable amount to produce a yield equivalent to the rental yield under a long-term ground lease, the required sales price is often significantly above the then

market price of the property. That is, it is simply not economic for the fee owner to sell. Therefore, if the fee owner wishes to participate in the redevelopment opportunity but not in an active fashion, it opts for a ground lease.

The ground lease under a portion of 885 Third Avenue – the so-called Lipstick Building – is an example of this circumstance. When that site was assembled in the early 80's, it contained a mix of brownstone type low-rise buildings. The ownership of one part of the site had been in a particular family for a substantial period of time and, on sale, would have generated a very large capital gain. Rather than incur that cost, the family refused to sell the property to the developer that was assembling the entire site. Rather, it insisted upon a long-term ground lease. These situations establish interesting economic dynamics as upon lease expiration the descendants of the original ground lessor, if still the fee owners, will become owners of a part interest in one of the most recognizable buildings in New York City.