

# Common Misconceptions About Ground Leases

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Some ideas about how ground leases work are outdated, misconstrued, or just plain wrong.

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Long-term owners of potential development sites who aren't in the real estate business sometimes consider entering into a ground lease with a developer. But they worry about the transaction structure, based perhaps on lack of knowledge. Here are some common fallacies about ground leases and why property owners shouldn't worry about them, or at least should know how to handle them.

*Fallacy #1: The owner might lose its interest in the property.* Many decades ago, developers used to demand that property owners put their interest in the property at risk to support the developer's initial construction loan. Allegedly, owner and tenant were "in it together" and this would help get the project built. So when the developer mortgaged its interest in the lease,

the owner would also have to mortgage its interest in the property to the same lender to provide more security for the developer's loan. Those transactions created way too much risk for most property owners. They have pretty much fallen by the wayside.

Instead, when a lender finances a modern development project on a lease, they just take the tenant's interest in the lease as security. If the lender forecloses, they only acquire the developer's leasehold interest. The owner and its underlying ownership position remain unscathed. (The owner still needs to worry about some mechanics' liens, but that varies from state to state, is typically manageable, and requires a different discussion.)

*Fallacy #2: In New York, ground leases shouldn't be longer than 49 years.* That's because ground leases attract a transfer tax if they exceed 49 years. But the transfer tax on a ground lease is relatively low compared to New York transfer taxes on other real estate transactions. Avoidance of that transfer tax is hardly something that should drive one of the most fundamental terms of the transaction. A 99-year ground lease is far more valuable to the developer than a 49-year ground lease. The owner should be able to make a better deal (i.e., obtain a higher starting rent) by offering a 99-year term, the incremental value of which to the owner should far exceed the modest transfer tax payable.

*Fallacy #3: The owner can just clip coupons.* That's not quite true. Even if the owner is entirely passive, it needs to pay attention to what the developer is doing over the long term of the ground lease. The owner should at a minimum make sure the real estate taxes are paid and the developer provides the required insurance. The owner will often have other rights to monitor the transaction, and should make some effort to exercise those rights.

*Fallacy #4: The owner won't be able to get a mortgage.* That's because the developer and its lender will typically insist that if the owner gets a mortgage, it must be "subordinate" to the ground lease, so that if the owner's lender forecloses, that can't terminate or impair the ground lease. Some narrow-minded lenders can't deal with that, because the checklist on their clipboard says their mortgage must always be "prior to" all leases, even if the lender is happy to commit that it won't try to terminate any leases in a foreclosure. The owner may find that some lenders shy away because of that problem. There will still be plenty of lenders willing to finance the owner's position, as a high-quality ground lease will often deliver a very reliable rent stream and thus great collateral.

*Fallacy #5: As soon as the owner signs a ground lease, the owner can obtain a large mortgage.* That's not true, either. Typically, lenders that lend to owners of ground-leased property will hesitate to provide much financing until the developer has completed its initial development of the project. At that point, the ground rent usually becomes very stable and reliable, because the completed building effectively becomes the world's largest security deposit. The present value of the ground rent will typically be around a third of the value of the land and building together as if the ground lease did not exist. That means the owner has

a position similar to a 33% loan-to-value mortgage, which is quite stable and solid. But that isn't true until the developer finishes its initial construction. Until then, any lenders to the owner will be skeptical or worse and will think of the collateral as little more than undeveloped land. That means the owner cares a lot about making sure that the developer completes and pays for its project and does so in a finite time.

*Fallacy #6: The developer will always expect to get a purchase option or at least a right of first offer.* Developers sometimes do ask for the former, and often for the latter. In most cases, though, the owner can – and should – resist the request. Most ground leases don't contain these provisions, which are often lethal because of the risk of litigation that they create.

*Fallacy #7: Over time, ground rent won't keep up with inflation and the owner will suffer.* That was certainly true with many ground leases signed a few decades, or longer, ago. Modern ground leases build in some inflation protection for the owner, although it's not always perfect or complete. The owner can get comfortable with that, though, by persuading the developer to agree to a generous starting rent. The owner can then look at the overall net present value of the deal as a whole. In calculating the net present value, the owner should use an appropriate discount rate. It should reflect, among many things, the perceived risk of inflation. That net present value will often exceed the net present value of any alternative transaction, or of the option of doing nothing at all.

*Fallacy #8: A ground lease is a quick, simple, and standard transaction.* Not exactly. Although many elements of a ground lease have become pretty consistent across the market, each transaction ends up involving extensive negotiations. That's because each party has its own agenda, needs, and concerns. Typically, there's always something about the property that ends up rippling through multiple provisions of the ground lease. The lease document needs to be correct throughout, since the parties will have to live with their document for a century or so.

For more on this topic, check out [www.groundleasebook.com](http://www.groundleasebook.com).

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