



GROUND LEASES: BASICS AND IMPORTANT ISSUES IN TODAY'S MARKET

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GROUND LEASES: BASICS AND IMPORTANT ISSUES IN TODAY'S MARKET

I. INTRODUCTION

The history of ground leases can be traced back to 11th century in England, when ground leases were used to avoid a papal prohibition on usury. Today in the United States, the use of ground leases run the gamut from government bodies that ground lease land to developers for urban renewal programs or non-profits that can't sell a property outright to cash-strapped developers who are looking to eliminate the land acquisition costs from a deal and sale-leaseback transactions. Due to the lengthy term and complexity, ground leases have gotten a bad reputation, and some individuals avoid ground leases altogether. However, for those individuals who choose to enter into a ground lease, the importance of the attorneys' counsel on the terms of same cannot be understated. Although the contract provisions in a ground lease can be viewed through the lens of a more traditional commercial lease where a landlord owns the land and improvements and leases both to the tenant, the unique aspects of ground leases – unimproved property, to be improved by tenant, subject to a very long term – require unique considerations for the landlord, tenant and any involved lenders.

The purpose of this paper is to provide a brief overview of some important aspects of ground leases that may be encountered by an attorney who is negotiating a ground lease in today's market. This paper is in no way intended to be an exhaustive guide to all concepts that may be encountered during a ground lease negotiation. Further, the concepts discussed herein are predicated on the model scenario that includes a tract of raw land to be developed by a tenant during the term of the proposed ground lease. For the purposes of this paper, the terms "property owner" and "landlord", as well as "developer" and "tenant", are used interchangeably.

II. WHY A GROUND LEASE?

For many who are unfamiliar with the ground lease concept, their first thought after hearing of a potential ground lease transaction may be "wouldn't it make more sense for the parties to buy and sell or enter into a more traditional built-to-suit lease?" While there would be certain benefits associated with these strategies, there are several factors associated with ground leases that make them appealing alternatives for developers and property owners alike.

A. Developer Motivations

First and foremost, a ground lease allows a developer to participate in a deal without bringing as much up-front capital to the table. If the land was being purchased, a developer would be required to come to the table with a sufficient amount of capital to not only construct the improvements, but to also purchase the land.

A ground lease permits a developer to avoid paying both principle and interest under a loan to secure the acquisition of the land. However, this is not to say that the amount paid in rent during the life of the lease would not exceed that which the developer would have paid in both principal and interest to finance the purchase of the property.

Developers also have tax incentives to use a ground lease. Unlike the principal payments under a loan, the rental payments under a ground lease are fully deductible for federal income tax purposes. Additionally, an investment in the purchase of the land is non-depreciable for tax purposes – an investment the developer avoids by using a ground lease to acquire the right to use the land for a long period of time.

Further, a ground lease may provide an opportunity for a developer to be able to develop land that is desirable, but that a property owner is unwilling to sell. As discussed in the next section, some property owners are not willing to sell their property, and a ground lease can be a viable alternative in such a situation.

Lastly, as further discussed later, sometimes a property owner may be willing to subordinate its interest in the ground lease to the liens securing the developer's construction financing. Such a situation allows for the developer to reduce, sometimes drastically, the amount of equity that the developer is required to obtain, as the value of the land is used as additional equity for the loan.

B. Property Owner Motivations

Like developers, property owners have various motivations when determining whether or not to utilize a ground lease. First, entering into a ground lease allows a property owner to obtain an income stream from the property without making substantial initial and ongoing investments of both time and money that are associated with the development, management and operation of the property.

Property owners also have tax incentives to use a ground lease, as a ground lease allows property owners to avoid the payment of capital gains tax.

Next, in some instances a property owner may own neighboring property, the value of which may be highly dependent upon the condition and use of the ground leased property. By utilizing a ground lease rather than selling, a property owner has the ability to ensure that the ground leased property is maintained for non-competitive and/or complimentary uses, thus ensuring

that their neighboring property values are not negatively impacted by unwanted uses. Additionally, the ground lease structure offers an ideal scenario for property owners who wish to maintain a supervisory role over the development of the property. This is essential to many property owners, especially public entities seeking to achieve public policy goals (i.e. affordable housing, neighborhood revitalization, etc.).

Lastly, sentimental value cannot be understated. While some property owners wish to realize some financial gain from the ownership of their property, they are unwilling to sell their property due to an emotional attachment. Often, property is handed down from generation to generation, and families often view property ownership as a means of ensuring generational financial stability for their loved ones. A ground lease allows a property owner to realize a non-participatory financial gain from the ground lease, while also keeping the property in the family.

III. BASIC TERMS OF A GROUND LEASE

While a ground lease contains many of the same components of an ordinary commercial lease, there are terms that are unique to ground leases. This section is not meant to and does not provide an exhaustive list of all of the important provisions contained in a ground lease. However, this section does highlight several issues that may be encountered in the marketplace today.

A. Construction and Ownership of Improvements

Typically a ground lease involves raw land. However, in some cases a piece of property may include improvements that are to be torn down or significantly altered. In both cases, the tenant will be responsible for the construction of new improvements on the property. Unlike in an ordinary commercial lease, upon the expiration or earlier termination of a ground lease, the ownership of the improvements reverts from the tenant to the property owner.

Although the tenant will be solely responsible for the construction of the improvements, including the preparation of any necessary construction plans and specifications for the tenant's improvements, the landlord will typically wish to retain the right to review and approve those plans and specifications. Because the improvements will revert to the landlord upon the expiration or earlier termination of the lease, the landlord has an interest in ensuring that the improvements can be used by a large number of future potential users.

In some instances, a tenant may require that the improvements be demolished upon the expiration of the lease term. This is often the case for businesses whose buildings contain certain unique architectural features that are readily recognizable and synonymous with their

brands, such as fast food restaurants. These types of businesses have an interest in ensuring that future businesses are not allowed to use and benefit from the improvements upon the expiration or termination of the ground lease. In determining whether or not to allow such demolition, the landlord should consider the rental structure, length of the lease term, and the overall credit worthiness of the tenant.

B. Term

One of the key distinguishing factors of a ground lease is the lengthy term. Usually, the term of a ground lease is at least 35 years, but in many instances, a ground lease term could be for up to 99 years.

Because a ground lease typically involves the construction of the improvements, the term of a ground lease is generally long enough to allow the tenant to entitle (i.e. obtain zoning, permitting, etc.) and construct the improvements, and to amortize the cost of the improvements over a period of time sufficient to generate income to not only pay for the improvements, but to realize a desired return. Additionally, in the event financing is obtained, the lender's requirements will often dictate the term of the lease. Lenders generally require that the lease term be longer than the amortization period of the loan. Should a tenant not require third party financing for its project, it may seek a shorter lease term with renewal options.

C. Permitted Use

As is the case in an ordinary commercial lease, the landlord will often seek to restrict the tenant's ability to use the property as much as possible. Landlords will often require that they have the final approval rights with respect to any proposed changes in the use of the property. This is especially true if the landlord is to be paid percentage rental under the lease, as the use of the property will directly impact the amount of money that the landlord receives. Furthermore, if the landlord owns neighboring property, any change of use has the potential to have a negative impact on the market value of that property.

On the other hand, due to the lengthy lease term coupled with market forces that could lead to the future unviability of the tenant's permitted use, a tenant will often seek a less restrictive permitted use. Tenants will often seek to have complete control over any future changes in the use of the property. This is often achieved by including language in the ground lease that allows the tenant to use the property for "any lawful purpose." Should the landlord require that consent be obtained for any change to the permitted use, tenants will generally request that the landlord's consent not be "unreasonably withheld, conditioned or delayed." Should a tenant insist upon the use of a reasonableness standard or a broad permitted use provision, a landlord may require that the

lease include a list of prohibited uses. This is a reasonable fallback position for a landlord, as it allows the landlord to maintain a certain level of control, while also granting to tenant flexibility over the lengthy term of the lease.

D. Rental Structure

1. Fixed Rent

The simplest method of determining rent is fixed rent. Fixed rent is often calculated based on the value of the property using the market or submarket's capitalization rate (also known as a "cap rate"). For example, if the market's capitalization rate is 6%, then the yearly fixed rent for a property worth \$1,000,000.00 would be \$60,000.00. Of course, this yearly rent is likely just a starting point for negotiations.

Further, fixed rent is almost always accompanied by yearly rent increases to account for inflation and other market trends. These rent increases are calculated based upon the prior year's fixed rent. Rent increases can be contrasted with a rent reset provision.

Lenders typically prefer that a ground lease contain fixed rental payments. The inclusion of fixed rental payments provides the lender some certainty for purposes of making debt service coverage calculations in underwriting the loan.

2. Adjustable Rent

When negotiating rent, the landlord and the tenant have competing interests. While the tenant has an interest in keeping the rent low throughout the term of the lease, the landlord has an interest in ensuring that it has the ability to participate in future increases in the property value. To achieve this goal, landlords will often require a rent reset provision that provides for rent increases at a few stages during the lease term (usually every 20 or 30 years). Such adjustments can be achieved through various methodologies. In some situations the basis for the increase is the U.S. Bureau of Labor Standards Cost Price Index for the relevant market area. In other cases, a lease may require that the rent be adjusted to equal an amount equal to a certain percentage (often between 5% and 7%) of the fair market value of the land at the time of the reset.

Note that traditional rent resets for ground leases are based on the fair market value of the *land*. Of course, that makes sense for *ground* leases. A tenant's attorney may try to insert language that the land valuation be reset based on comparable land value without improvements. The value may be based on tenant's use or it may be based on the highest and best use of the land – a decision that can significantly affect the future value. In contrast, a landlord's attorney may seek language that allows for more generous revaluations. Care should be given to drafting rent reset provisions so that there is no ambiguity for attorneys

decades later reviewing these provisions that conflates terms like "property," "premises," and "building." Further, appraisers should be given specific instructions on what assumptions, indexes, and markets to evaluate. Well-drafted rent reset provisions will help keep the parties out of court, especially when the original drafters are long gone.

The above-referenced structure has become somewhat problematic in recent years and in some markets in which interest rates are low and therefore market capitalization rates are low. In such instances, land values are driven higher. Therefore, the rental increase will be substantial, which could lead to the ground lease no longer being economically viable for the tenant.

3. Percentage Rent

Percentage rent is rent paid by a tenant based on the tenant's gross sales. As with ordinary commercial leases, some landlords favor percentage rent because it allows them to benefit financially from a tenant's thriving business. Of course, the converse is true if a tenant's sales dry up.

From a tenant's perspective, the use of percentage rent structure may allow a tenant to negotiate a lower base rent, which can lower the tenant's minimum monthly rent.

Often, percentage rent is accompanied by the use of break points. A break point is the gross-sales threshold after which percentage rent is paid and at which percentage rent is calculated. For example, a ground lease may have a 10%/\$100,000.00 break point. For a given month where the tenant has \$150,000.00 in sales, the tenant would owe additional percentage rent of \$5,000.00 (10 percent of the \$50,000.00 excess over the \$100,000.00 break point).

If a lease includes percentage rent, the landlord should require a continuous operations clause. Such a clause will require that the tenant continually maintains operations in the leased premises during the term of the lease, so there is no interruption to the landlord's receipt of percentage rent. Tenants and lenders are often resistant to the inclusion of a continuous operations clause. As a compromise, tenants will often grant the landlord termination rights should the tenant fail (sometimes upon receipt of written notice and an opportunity to cure) to continue to operate for a specified period of time.

In addition to the continuous operations clause, the landlord should require that it has the right to audit tenant's books. Auditing rights are vital to ensuring that the tenant is properly reporting its gross sales, and thus paying the landlord all the money that it is due. Often a landlord will require the tenant to reimburse the landlord for the expenses associated with its audit should it be

discovered that tenant understated its gross sales by more than 1 or 2 percent in any given calendar year.

4. Payment of Insurance Premiums

Tenants will be required to pay for and maintain throughout the term of the lease property and liability insurance with respect to the leased premises and the improvements. The coverage amounts are typically negotiated and should be included in the lease.

5. Payment of Taxes and Assessments

A ground lease will typically require that the tenant pay any and all taxes and assessments on the leased premises during the term of the lease. However, the tenant should only be required to pay its prorated share of taxes for any partial lease year.

As is the case in an ordinary commercial lease, should the leased premises be a part of a larger tax parcel, the parties will be required to agree on the procedure for determining the proper allocation of taxes for the leased premises. In such an event, the landlord will be required to pay all taxes associated with the non-leased property. The best course of action, however, is for the parties to work together to cause the leased premises to be assessed as a separate tax parcel by the local taxing authorities.

6. Payment of Other Costs and Expenses

The tenant will be required to pay for all other costs and expenses related to the construction, ownership, improvement or operation of the leased premises. Such costs may include: (i) payments for assessments to property/homeowners associations; (ii) costs incurred in obtaining any necessary zoning; (iii) costs incurred in obtaining approval of any necessary plat/replat; (iv) impact fees and other costs associated with the extension of utilities to the leased premises; and (v) building permit fees and the fees associated with other approvals necessary for the construction and subsequent operation in the leased premises.

E. Assignment and Subletting

1. Assignment by Landlord

A landlord will generally require that it have the right to freely assign its interest in the ground lease to any party without any restrictions or required consents from tenant or tenant's lender. Additionally, as mentioned earlier, the landlord will typically want the right to encumber its interest in the property to secure a loan, subject to any rights of tenant to require an SNDA.

2. Assignment by Tenant

Typically a landlord will require that it have the right to consent to any proposed assignment or sublease of the ground lease. A landlord's first position will most likely be that it have the sole discretion with respect to

any proposed assignment or sublease. When a landlord is determining whether or not to enter into a lease with a particular tenant, it is often making a decision that has been informed by a review of that tenant's ability to construct the improvements and its credit-worthiness to pay rent. In some instances a landlord may be willing to agree to a reasonableness standard whereby it is prohibited from unreasonably withholding, conditioning or delaying their consent to any proposed sublease or assignment. Should a landlord agree to include a reasonableness standard, it may consider including a "net-worth" or "credit-worthiness" requirement, so it can withhold its consent if the proposed assignee or subtenant fails to meet these standards.

3. Subletting by Tenant

Many landlords are unconcerned with a tenant's subleasing activities under a ground lease. Ultimately, the tenant will be on the hook for all obligations under the ground lease, regardless of the existence of any sublease. That said, a landlord will want to ensure that the ground lease contains a prohibition on subleases that have terms extending beyond the term of the ground lease. Furthermore, a landlord may be more concerned with a tenant's subleasing activities should the lease provide for the payment of percentage rent, or if the lease provides for rental adjustments based on a land valuation that takes into account the income generated from the premises.

F. Casualty and Condemnation

Should the land or improvements be damaged or destroyed due to a casualty or condemnation, the landlord will typically want the tenant to repair and/or reconstruct the improvements. This is because landlord wishes to realize the economic gain associated with its reversionary interest in the improvements upon the expiration or termination of the lease. As an alternative, should a tenant not be required to repair and/or reconstruct the improvements, the landlord will typically require that it receive some share of the insurance proceeds which reflects the reversionary interest of the landlord in the improvements.

In the event that tenant is required to repair and/or reconstruct the improvements, the landlord will generally require that the tenant obtain the same approvals from landlord and comply with the same conditions that were in place at the time of the initial construction of the improvements.

If the casualty or condemnation event takes place near the end of the term of the ground lease, the tenant will usually not want to be obligated to repair or reconstruct the leased premises. The tenant will also not want to reconstruct the improvements in the event that its lender is entitled to apply the insurance or

condemnation proceeds to the loan secured by the tenant's leasehold interest.

IV. FINANCING CONSIDERATIONS

Because a tenant is required to construct its improvements, obtaining financing is often imperative. Without financing, many tenants would not have sufficient capital to construct their improvements. However, there are various considerations that will come into play prior to a lender offering financing to a tenant under a ground lease. Furthermore, there may be instances where the landlord has obtained financing that is secured by its interest in the land. In those instances, special attention should be paid to both the requirements of the landlord's lender, as well as the unique interplay between the landlord's lender and the tenant's lender. It's unlikely that landlord and tenant can predict all of the lender requirements. Therefore, in many instances it is essential that the parties to a ground lease involve the lender in the negotiations. Otherwise, issues that could be resolved in the original ground lease are left to uncertain contract amendments.

A. To Subordinate or Not to Subordinate?

As discussed, one of the key motivations of a property owner in choosing to utilize a ground lease is the low up-front costs and the overall decrease in risk exposure. To further minimize its risk, a property owner would ideally want an unsubordinated ground lease. Any construction financing obtained by the tenant is secured by only the tenant's interest in the lease.

In certain instances, a developer will require that a landlord subordinate its interest in a ground lease to the liens securing the tenants financing for the construction, management, operation and development of the proposed project. Such a structure is risky for a landlord, as any default by the tenant under the loan may permit the lender to wipe out the landlord's interest in the land by foreclosing the lien securing the tenant's financing. However, in some instances a tenant's lender will require such a structure in order to provide the financing. In any situation in which a landlord subordinates its interest in the property to a tenant's financing, the lease must include sufficient protections for the landlord, as discussed below.

An unsubordinated ground lease is ideal for a landlord. Should the tenant default on its loan, the lender will have the ability to foreclose on the tenant's interest in the ground lease, but such a foreclosure will not affect the landlord's interest in the land. This is a riskier proposition for the lender and will often result in less favorable loan terms for the tenant because the lender is unable to include the land as part of the collateral pool. In such a situation, lenders will often negotiate for additional protections in the lease.

B. Protections for Subordinated Property Owners

Should a landlord agree to subordinate its interest in the ground lease to the liens securing the tenant's financing, the landlord should require that certain protections be included in the ground lease.

1. Security Deposit

First, a landlord may propose that the tenant deposit a large security deposit, which will act as security, not only in the case where tenant defaults under the ground lease but also in the event that tenant fails to meet its obligations under its loan. However, it should be understood that this protection should be used to supplement any additional protections, as the amount of the security deposit will likely be significantly less than the value of the land.

2. Increased Rent

Should a landlord be required to subordinate its interest, it may require the tenant to pay a higher rental rate. This will be offset the increased risk to landlord associated with a potential foreclosure of its interest in the land.

3. Notice and Opportunity to Cure

Next, a landlord should require that a tenant's lender give the landlord notice of and an opportunity to cure any defaults by tenant under the loan. Generally, the landlord will require that it receive such notice at the same time as tenant. The landlord should require that the notice specify the nature of the alleged default and describe the actions that need to be taken in order to cure the default.

C. Lender Protections

Should a landlord's interest not be subordinated, then the lender will likely require that the lease contain some additional protections.

1. Use Provision

While a landlord may wish to negotiate a limited use provision, a lender will typically require a broad use provision, such that the leasehold can be sold if the original tenant's business plan proves unviable. A broad use provision, such as one that allows for "any lawful use", will broaden the pool of potential buyers. As a compromise to a very broad use provision, landlords may propose a list of prohibited uses.

2. Right to Cure Provisions

Lenders will often require that landlords provide them notice of and an opportunity to cure any alleged tenant defaults. Such a notice should specify the nature of the alleged default and describe the actions that need to be taken in order to cure the default.

3. Assignment

In addition to the inclusion of a broad permitted use provision, lenders will often require that the lease be freely assignable without the need for landlord's consent should the lender be required to foreclose.

4. Anti-Merger

The lender will often require that the ground lease contain an "anti-merger" provision. Such a provision will ensure that the leasehold interest under the ground lease will not merge into the fee interest of the leased premises upon the termination of the ground lease.

5. Amendment Consent

The lender will often request that the ground lease not be amended without its consent. From a landlord's perspective, obtaining lender consent for every amendment could become a logistical nightmare. As a compromise, landlords may propose that no "material" amendments be entered into without the lender's consent. However, such a compromise could open the door to additional disputes with lender as to what is or is not material.

D. Casualty and Condemnation

In the event of a casualty or condemnation event, the lender will typically maintain control over the tenant's insurance proceeds. The lender will typically wish to participate in the adjustment of the insurance proceeds and in any condemnation proceedings. In most instances, the lender will want the insurance proceeds to be applied to the loan rather than to the repair or reconstruction of the lease premises.

E. Landlord Mortgage for Fee Interest in Land

In an ordinary commercial lease, the landlord owns the land and the improvements. In some instances, the landlord may own the property subject to a lender's interest. In a ground lease transaction, however, there may be two lenders that need to be considered. While the landlord and tenant must consider the needs of the lender financing the construction of tenant's improvements, consideration must also be given to any lender who has provided financing or will provide financing that is secured by the landlord's fee interest in the land.

Unless otherwise subordinated, a loan securing landlord's fee interest in the land will be superior to a later-executed ground lease and any associated lien to secure improvements on the land. The tenant's lender is unlikely to allow a superior interest, especially if the tenant's lender is putting the greatest amount of money

into the deal. In other scenarios, a loan securing landlord's fee interest obtained *after* the ground lease and improvements lien are in place would be inferior.

If there is an existing lien against the property with another lender, the tenant's lender will try to obtain a subordination, non-disturbance and attornment agreement. Otherwise, any foreclosure of the prior lien securing the land might wipe out the financing lender's interest in the lease and improvements. Looking ahead, the financing lender will also want to ensure any future financing of the land by the landlord does not unnecessarily put at risk its interest. Therefore, the tenant's lender will require that any future lien against the property expressly guarantees that the ground lease will survive such a foreclosure.

V. ISSUES RELATED TO GROUND LEASES ACCOUNTING

We are attorneys, not accountants, but we are often asked to wear many hats when advising clients. Therefore, it is helpful for the commercial real estate attorney to have a general understanding of the new lease guidance in the Generally Accepted Accounting Practices (GAAP) from the Financial Accounting Standard Board.

For tenants (lessees), the guidance has significantly changed. "The core principle of [the new GAAP lease provisions are] that a lessee should recognize the assets and liabilities that arise from leases."¹ Past guidance allowed tenants to keep such assets and liabilities off their balance sheets. This posed not only an issue of evaluating a lessee's independent financial position, but it also made comparing comparable entities' strengths and weaknesses difficult.

At the simplest level, from the lessee's perspective, the primary lease liability is the obligation to pay rent. The primary lease asset is the right to use the underlying asset. Under the new GAAP standards, users of financial statements should be able to more easily analyze and compare entities that are parties to leases, including ground leases. Further, for ground leases under the new guidance, the right-to-use asset may be treated similarly during the construction period and for the remaining term of the ground lease.

For landlords (lessors), the guidance is largely the same. Under the new accounting standards, landlords should continue recognizing their lease assets and liabilities on their balance sheets.

From an accounting perspective, ground lease tenants may see a change in their financial position. The desirability of ground leases, then, may change when the new standards are fully implemented. Expect most

¹ See ASU 2016-02, Leases (Topic 842), available at https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176167901010

entities to implement these new standards beginning in 2020 or 2021, depending on the entity's size and type.

VI. CONCLUSION

Although they have received a bad reputation in some circles, the terms and provisions contained in a ground lease can be negotiated in such a way that they allow both property owners and developers to achieve a variety of financial and business goals. A ground lease provides many benefits and also poses many risks to the unexperienced practitioner. For the right client, a ground lease can provide the best value to landlord, tenant, and lender. By understanding the risk and benefits, as well as the typical party's motivations, an attorney working on a ground lease can best prepare his client for the unlikely eventualities that may face a party to a ground lease – whether they come in the first year or the ninety-ninth.