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Under All is the Land: Ground Leases and Hospital Campuses

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There is an old adage in real estate that states that "under all is the land." [1] This statement is quite literally true when dealing with ground leases upon which buildings are constructed. Within the health care real estate sector, it is common for hospitals to utilize a ground lease to facilitate the development of a new building. Most often, these arrangements are pursued on hospital campuses, where hospitals may prefer to retain a greater degree of control over a new development than would exist if they sold the land. The ground lessee entity may be a real estate investment trust (REIT), a physician group, a developer, or another third-party. A ground lease allows a hospital to retain long term control of the site, along with the ability to have certain controls over the development and leasing of the building. A hospital's motivations for pursuing a ground lease structure may also stem from a variety of other strategic or economic objectives, such as freeing up capital for other uses.[2] A developer may prefer to acquire the land, though a ground lease structure does provide the developer with the advantage of slightly lower total capital requirements (as they do not need to purchase the land).

This article will provide an overview of valuation considerations associated with ground leases; explain key attributes of on-campus ground leases; evaluate ground-lease related compliance risks; and discuss key issues such as ROFRs, options, use restrictions, and more.

What is a ground lease?

A ground lease is defined by Black's Law Dictionary as "*a lease of vacant land, or land exclusive of any buildings on it, or unimproved real property. Usually a net lease."*[3] The Dictionary of Real Estate Appraisal defines a ground lease as "*a lease that grants the right to use and occupy land. Improvements made by the ground lessee typically revert to the ground lessor at the end of the lease term*."[4]

When an entity owns real estate without any leases (or other ownership interests) in place, the entity generally owns the "fee simple estate" in the real estate. Fee simple estate is defined as "*absolute ownership unencumbered by any other interest or estate, subject only to the limitation imposed by the governmental powers of taxation, eminent domain, police power, and escheat*."[5] Ownership of the fee simple estate could encompass solely vacant land or could encompass land and improvements. When a ground lease is executed, separation of ownership between building and improvements occurs, and both a "leased fee estate" (for the lessor) and a "leasehold estate" (for the lessee) are created. Leased fee estate is defined as "*the ownership interest held by the lessor, which includes the right to receive the contract rent*

specified in the lease plus the reversionary right when the lease expires."[6] Leasehold estate is defined as "*the right held by the lessee to use and occupy real estate for a stated term and under the conditions specified in the lease."*[7] When a developer is in the lessee position on the ground lease and the lessor position on the building lease, their position is sometimes referred to as a "sandwich interest," or "sandwich lease."[8]

Ground leases are typically long term (50+ years), with term lengths sufficient for the ground lessee to control the improvements for the duration of their economic life. When hospitals and developers are negotiating ground lease terms, hospitals (as lessors) will typically seek leasing control provisions, rights of first offer (ROFOs), rights of first refusal (ROFRs), use restrictions, development approvals, and so forth. Comparatively, developers will seek more flexibility in their ability to lease, develop, and sell the building (such as provisions which loosen any leasing controls in the event that certain performance thresholds are not achieved by the host hospital).[9] Parking is another item that will often be negotiated, with a developer seeking parking that is as proximate as possible to the building, while the hospital may seek to retain more flexibility to accommodate future building plans. Financing the leasehold interest can also be more challenging, and lessor and lessee will need to ensure that the ground lease is structured such that it is "financeable."[10]

What are valuation considerations associated with a hospital ground lease?

Appraisers, brokers, and other real estate analysts most commonly value land via analysis of sales of other "comparable" land transactions. Land values are typically discussed on a per unit basis, such as per square foot or per acre of land area. In higher density urban locations, land prices may be more closely correlated with price per FAR (floor area ratio). Land prices may also be correlated with other factors (corner locations, highway visibility, ocean frontage, etc.). A full discussion of land valuation is beyond the scope of this article, but the pertinent takeaway within the context of ground leases is that a ground lease payment will often reflect a percentage of the "fee simple" value of the land. This percentage can also be thought of as a rate of return, or an overall capitalization rate (cap rate).[11] For instance, if a parcel of land is worth $1,000,000 and a 50-year ground lease starts at a rent rate of $60,000 per year, the cap rate would be 6.0% ($60,000 divided by $1,000,000). If a ground lease is near the end of its term, or the ground rent is not at market, then a cap rate analysis may not be appropriate.[12]

Within most commercial real estate market sectors, buyers and sellers frequently evaluate properties based on their cap rates, which are essentially a reflection of perceived risk and anticipated yield. As land does not depreciate, land cap rates (i.e. ground lease cap rates) tend to be lower than building cap rates, as they reflect a lower risk profile. However, a myriad of factors impact the cap rate at which actual transactions are executed, including (but not limited to): (a) tenant creditworthiness; (b) financing terms associated with the transaction; (c) remaining term length; (d) lease escalations and other lease terms; (e) a property's location and physical characteristics; (f) lease renewal probability (if the term will expire in the near future); (g) anticipated reversion; (h) trends in the capital markets; (i) industry specific trends; (j) buyer and seller motivations; and (k) current lease rate relative to market. Other risk factors

specific to ground leases include whether the ground lease is subordinated, default and casualty terms, use restrictions, market rent resets, subleasing provisions, and more. In general commercial real estate, ground lease structures have become more complex, giving rise to correspondingly complicated valuation and legal issues.[13]

General ranges of cap rates across certain asset classes, with specific tenants, or in certain geographic regions can be observed. Long term ground leases with strong credit tenants (typically nationally branded restaurants and drugstores) can sell for cap rates at or below 3%.[14] The first ground lease focused REIT (*NYSE: SAFE*) was launched in 2017 (first launched as "Safety, Income & Growth" then rebranded to Safehold, Inc). As of 2018, per public filings, this REIT was focused on properties in major metro areas. According to publicly available investor presentations, SAFE was seeking first year rent yields of 3.0% to 5.0% (as of 2018), initial term lengths of 30 to 99 years, and rent escalators that were "period fixed or CPI-escalators or percent rent participations." SAFE also seeks ground rent coverage of 2.0x to 5.0x for the first year of the lease.

Specific to the health care industry, third party surveys conducted in 2018 and 2019 with health care real estate investors and developers revealed the majority of respondents (slightly over 50%) indicated a ground rent cap rate between 5% and 6%. The referenced survey was conducted by CBRE and the survey question was "*when working with a hospital to structure a ground lease, an investor or developer will typically use the footprint of the building, plus a 5-to-10-foot apron, to determine the annual cost to lease the ground. For an on-campus MOB, what do you believe is a fair percentage of the land value to use in the calculation to determine annual rent under the ground lease?"*[15]

Across most commercial property sectors, stronger real estate markets with lower risk profiles will typically feature lower ground cap rates. VMG conducted two studies in 2018 of non-health care commercial property ground leases, one in California and one in the northeastern United States. VMG analyzed published cap rates for 45 total ground lease transactions. Combined, these two studies featured 25th and 75th percentile ground lease cap rates of 3.60% and 5.00%, with a median of 4.35%. This dataset generally reflected high quality locations and lower risk tenants (albeit predominately non-health care).[16]

Occasionally, the ground lease position within a multi-story office building in a central business district (CBD) will also sell. As income generated from the ground lease is less risky than income generated from the building, ground lease cap rates for these assets will generally be lower as compared to sales of similar buildings without ground leases in place. This is illustrated by the previously referenced cap rate data noted in SAFE's investment criteria.

Ground leases on hospital campuses feature nuances that generally do not exist in ground leases for commercial buildings such as offices, restaurants, drugstores, or convenience stores. For instance, in cases where solely the building footprint (plus a 5- to 10-foot perimeter) on a hospital campus is leased, the ground rent payment will typically account for usage of additional non-exclusive land area that facilitates parking, pedestrian access, vehicular

ingress/egress, and drainage. Some ground lease rent payments also implicitly include use of a parking structure, skybridges, or other building costs, while others are reflective of solely raw land. Accordingly, the ground rent payment as a function of the actual leased land area can sometimes be misleading. In these cases, the ground rent may be more effectively analyzed as a function of the total building square footage. Therefore, it is critical for the analyst to understand what is and what is not included within the ground lease payment, to ensure that there is no omission or double counting when evaluating the total rent that a building subtenant will pay.

VMG has analyzed ground leases for newly constructed health care assets situated on hospital campuses. A dataset of 16 on-campus ground leases[17] revealed the following benchmarks: initial term lengths ranged from 25 to 75 years, with the median being 50 years. VMG has analyzed these ground rents on a per square foot of building area basis, as well as on a per square foot of land area basis. Indications per square foot of building area vary widely. Most leases within this dataset included tenant options to renew. Observed escalation structures ranged significantly, with some leases featuring a flat rent while others featured step structures (i.e. 10% every five years, or periodic market-based adjustments) and others featured annual increases of 2% to 3% or CPI-based. There is a variety of published literature[18] that provides commentary on various methodologies to adjust ground leases over the course of the term;[19] however, a unique consideration specific to ground leases in the health care sector is navigating the Stark Law and the Anti-Kickback Statute (AKS) at the time an option is exercised, as will be discussed later in this article.

Lenders on a ground lease loan must determine if the ground lease lessor will “subordinate” its fee simple interest in the land to the lien of the lender’s mortgage. If the ground lease is subordinated, the owner (lessor) is offering land as collateral for the leasehold mortgage (held by the developer), with the result being that the landowner has significant development risk. In this structure, the subordinated ground lessor is a “secondary lender with junior rights behind the primary lender, usually a bank or other financial institution.”[20] Typical initial term lengths for ground leases are 50 years or longer, and the expense structure is typically “absolute net,” with the tenant paying all property expenses.[21] Many other factors must be considered in structuring ground leases, including (but not limited to): default, casualty loss, use restrictions, market rent resets, assignments, subleasing, and construction timing. The technical, legal issues associated with drafting ground leases are numerous and are beyond the scope of this article (see further discussion in the end notes).[22]

What are some compliance risks associated with ground leases?

Parties to a ground lease must be aware of regulatory implications associated with the lease. Even if a ground lease is executed between a REIT and a hospital, if the ground lease payment is also being passed through to sublease entities who are referral sources, the arrangement may need to be evaluated on a fair market value[23] (FMV) and commercial reasonableness[24] (CR) basis.

In a typical development scenario, a hospital may engage a developer to construct a new medical office building (MOB) on the hospital's campus. The hospital may lease the land (often solely the building footprint plus a 5- to 10-foot perimeter, as previously mentioned) to the developer via a long term ground lease. The developer will then construct the building and lease it back to the hospital (and potentially other subtenants). If the hospital is leasing 100% of the building from the developer, the hospital will then be in both a lessor position (in the ground lease) and a sublessee position (as the lessee of the building master lease). If the hospital is subleasing space within the building to physicians, the physicians may be in sub-sublessee positions. In this case, the hospital should be careful to ensure that the total rent paid by the sub-subtenant is consistent with FMV, particularly if the ground rent is for an amount other than market.

In cases where the ground rent paid is below FMV (sometimes ground rent is set at a nominal amount, such as one dollar per year, and offset via other considerations), the parties should be cognizant that sublessees (or sub-sublessees) do not wind up benefiting from an artificially low base lease rate (since no market ground rent is being passed through, and the market value of the land is not implicit in the base rent). For instance, a developer who was not being charged a market ground rent could lease space in a building at a lower gross rent rate than would otherwise be possible. This could be construed as a benefit for a sublessee (or a sub-sublessee) in the building.

Ownership in the building may also be structured such that physician tenants may participate on an equity basis in a joint venture that owns the building (alongside the developer and possibly the hospital, if the hospital maintains any equity ownership in the building). In cases where physicians are limited partners or members in the entity that develops the building, the Stark Law may be applicable.

Newly developed MOBs built via agreements with third-party developers have attracted regulatory scrutiny. For instance, in July 2019, the Eleventh Circuit upheld the Southern District of Florida's decision to dismiss a qui tam claim brought by a whistleblower, who alleged that HCA violated the False Claims Act (*See Bingham v. HCA, Inc*., Case No. 1:13-cv-23671 (11th Cir. 2019)). This case involved a third-party developer ground leasing land at Centerpoint Medical Center from HCA to facilitate development of a new MOB. In this case, the whistleblower asserted that subsidies were passed through to the physicians, with some of the subsidies tied to parking facilities and free parking. While this case was ultimately dismissed, it serves as an example for hospitals to tread carefully when structuring complex on-campus ground lease arrangements.

ROFOs, ROFRs, Purchase Options, and Put Options

Rights of first offer (ROFOs) and rights of first refusal (ROFRs) are commonly included in ground lease negotiations. Sometimes the master building lease and the ground lease may both include ROFOs, ROFRs, purchase options, or put options. The terms can be confusing and are sometimes misused in the marketplace. Generally, the intention of the parties is that, if

an entity has a ROFO, they have the right to make the first offer on a property if a seller intends to sell it, whereas if an entity has a ROFR, they have the right to match any offer received. There are nuances and complexities associated with these terms, and ROFOs and ROFRs should be carefully drafted and interpreted.

Furthermore, at the time an option is exercised, the terms of the option (if Stark or AKS are implicated) should be evaluated for FMV and CR to ensure that any purchase option or renewal option is compliant (at the time). Rental adjustment clauses tied to FMV must be carefully drafted to ensure that the methodology by which FMV is established aligns with the lessor's and lessee's expectations at the time the ground lease was originally negotiated.

Third-party survey data has reported that hospitals typically exercise their ROFRs 10% to 30% of the time.[25] Survey respondents were also asked how often a purchase option on a ground lease includes a price floor. The majority of respondents (70%) noted that a price floor is included less than half the time, while 30% of respondents indicated that more than half of purchase options do not have a price floor. Furthermore, this survey noted that the vast majority (~90%) of real estate investors considered a minimum ground lease term length to be 50 years.

ROFR rights can have a significant impact, as was observed in one of the largest health care real estate transactions in the last decade. In May of 2017, a transaction was announced in which Duke Realty Corp. (*NYSE: DRE)* sold its MOB portfolio to Healthcare Trust of America (*NYSE: HTA)* for a maximum of $2.75 billion. Subsequent to the initial announcement, a series of properties within the portfolio sold to other buyers via ROFRs (in sum, more than $400 million of properties wound up being acquired via ROFRs exercised by various health systems).[26]

Use Restrictions and Other Issues

Within a health care setting, use restrictions are commonly a negotiated item in a ground lease. Residual value of the improvements (i.e. "reversionary rights") are also a subject of debate and negotiation.

Healthcare Realty Trust (*NYSE: HR*), a publicly traded, MOB focused REIT, disclosed in its 2018 Annual Report that about 40% of its total MOB holdings are located on ground leased sites. In previous annual filings, HR has reported that its ground leases "typically have initial terms of 50 to 75 years." HR has also noted that their ground lease agreements with hospitals and health systems "typically contain restrictions that limit building occupancy to physicians on the medical staff of an affiliated hospital and prohibit tenants from providing services that compete with the services provided by the affiliated hospital[…]" and that they "[…] contain provisions that may limit [HR]'s ability to lease, sell, or finance these properties."

A use restriction that does not affect the highest and best use of a property may have no material impact on a property's value. Conversely, if a use restriction prohibits the

development of a property to its highest and best use, the use restriction may have material value impact. This can be observed in other property sectors; for instance, certain big box retailers (such as Walmart) may sell outparcels that command a higher price than a similar nearby parcel, despite the fact that Walmart will often require the buyer to agree to certain use restrictions (a similar effect can be observed by examining rent rates at shadow-anchored strip retail centers as compared to similar strip retail centers located down the street). Similarly, a use restriction on an interior parcel within a hospital campus may have a different effect on value as compared to a use restriction for a corner site that features more varied development potential.

Residual value is also a consideration; ground leases executed in conjunction with the development of a new building typically feature ground lease terms of sufficient length for the ground lessee to fully realize the value of the improvements (or, if the initial term is shorter than the economic life of the improvements, the total cost may be amortized within the initial term such that the developer achieves return on and return of capital within the initial term, absent a reversion). For instance, if a ground lease has an initial lease term of 50 years with four five-year options, then the ground lessee has potential control of the site for 70 years. A typical economic life projection for a MOB (as published by various third-party entities that specialize in economic life estimates, such as Marshall Valuation Service) ranges from 45 to 50 years. Rationally, if economic life exists in the building at the end of the ground lease's initial term, the lessee would presumably exercise their renewal option so as to take advantage of the building's residual value.

Ground leases executed many years ago may wind up being above or below market, which could also create a positive or negative leasehold position. The potential existence of a positive or negative leasehold should be considered in the context of an acquisition or joint venture. For ground lease footprints, exclusive and non-exclusive rights (and reciprocal access easements) may need to be evaluated, along with other considerations. Additionally, total capital contributions made to a new development project by both the hospital (as ground lease lessor) and the developer (as ground lease lessee) should be carefully analyzed in order to ensure that the ground rent paid represents a market return.

Key Takeaways and Conclusions

A complex array of economic, strategic, and regulatory issues arise when a ground lease is utilized to facilitate a new development on a hospital campus. The varying interests of the land owner, the developer, and the building tenant must all be navigated. A vast literature providing guidance on options and pitfalls associated with ground lease structures in general commercial real estate exists. However, unique considerations must be evaluated that are specific to health care real estate ground leases, such as ground leases of building footprints on hospital campuses, or including garage (or skybridge) access within a ground rent payment. Ultimately, the parties to any on-campus ground lease transaction should carefully consider legal, financing, valuation, and regulatory issues, ensuring that the return received and the rent paid

is commercially reasonable and consistent with fair market value for the various lessors, sublessors, lessees, and sublessee.

[1] This phrase is stated as the first sentence in the preamble to the National Association of Realtor's Code of Ethics, https://www.nar.realtor/sites/default/files/policies/2007/code-of-ethics-preamble-2007-11-27.pdf.
[2] A strategic discussion of reasons that a hospital might pursue a ground lease structure is beyond the scope of this article. Capital allocation, tax considerations, property rights issues, and a variety of other factors are all considerations. Lease accounting also affects the decision of whether to pursue a ground lease structure (i.e. a comparative balance sheet analysis of leasing versus owning the underlying land).
[3] Black's Law Dictionary, Centennial Ed. (1891–1991), 6th ed., 704.
[4] Dictionary of Real Estate Appraisal, Sixth Edition.
[5] *Id.*
[6] *Id.*
[7] *Id.*
[8] *See Id.* "*A lease in which an intermediate, or sandwich, leaseholder is the lessee of one party and the lessor of another. The owner of the sandwich lease is neither the fee owner nor the user of the property; he or she may be a leaseholder in a chain of leases, excluding the ultimate sublessee*."
[9] Weller, Philip, *On Campus Medical Office Ground Leases,* Presented at the *University of Texas Law School Bernard O. Dow 2012 Leasing Institute*. October 3, 2012.
[10] Many law firms have published guidance regarding structuring financeable ground leases and leasehold mortgages, along with other nuanced issues related to ground leases. Joshua Stein, a New York based attorney, has published a 500+ page book (published in 2005) solely focused on ground leases. Another attorney, Jerome D. Whalen, has published a book (in 2013) titled "Commercial Ground Leases." A discussion of the nuances of leasehold mortgages and how navigating financing issues specific to ground leases is beyond the scope of this article. Moody's, among others, has also published guidance on underwriting considerations associated with ground lease financing.
[11] A cap rate is defined by The Dictionary of Real Estate Appraisal, 6th Edition, as "The relationship between a single year's net operating income expectancy and the total property or value (*RO = IO /VO*)."
[12] Richard, Frederick, *Valuation of Leasehold Improvements in a Ground Lease*, NEW ENGLAND REAL ESTATE JOURNAL (Oct. 19, 2018).
[13] A variety of industry literature addresses valuation issues specific to non-health care ground leases. Two recent examples include: DeWeese, Gary S. *Valuing the Leased Fee Interest Subject to a Ground Lease – How and Why the Details Matter*, THE APPRAISAL JOURNAL (Winter 2017); and Haapaniemi, Peter *Uncommon Ground*, VALUATION MAGAZINE (Q1 2017).
[14] https://srsre.com/media/mcdonald-s-ground-lease-in-azusa-sells-at-3-25-cap-rate.
[15] Bodnar, Chris et al., *CBRE 2019 Healthcare Real Estate Investor & Developer Survey,* CBRE U.S. HEALTHCARE CAPITAL MARKETS (2019).
[16] *See* VMG Health's internal health care real estate transaction database.
[17] *Id*.
[18] Sevelka, Tony, *Ground Leases: Rent Reset Valuation Issues*, THE APPRAISAL JOURNAL, p. 314-326 (Fall 2011).
[19] Stein, Joshua, *The Most Important Issue in Every Ground Lease*, N.Y. REAL PROPERTY LAW JOURNAL (Winter 2014, Vol. 42. No. 1).
[20] Himovitz, Phillip, *Ground Control: Owners and developers unearth opportunities through creative land leases*, CCIM INSTITUTE – CIRE MAGAZINE (July 2006).
[21] Mayne, Florence, *Ground Leases: Basic Legal Issues*, Association of University Real Estate Officials, 22nd Annual Meeting, University of Texas, Sept. 24, 2002.
[22] A detailed discussion of financing unsubordinated ground leases (and other key ground lease related issues) is found in Whalen, Jerome D., *Financing an Unsubordinated Ground Lease in the Twenty-First Century*, ABA PROBATE & PROPERTY MAGAZINE (Apr. 2019).
[23] Within a health care setting, FMV has additional limitations imposed by the Anti-Kickback Statute and the Stark Law. Under these limitations, health care FMV is generally defined by 42 CFR §411.351 as follows: "Fair market

value means the value in arm's-length transactions, consistent with the general market value. “General market value” means the price that an asset would bring as the result of bona fide bargaining between well-informed buyers and sellers who are not otherwise in a position to generate business for the other party, or the compensation that would be included in a service agreement as the result of bona fide bargaining between well-informed parties to the agreement who are not otherwise in a position to generate business for the other party, on the date of acquisition of the asset or at the time of the service agreement. Usually, the fair market price is the price at which bona fide sales have been consummated for assets of like type, quality, and quantity in a particular market at the time of acquisition, or the compensation that has been included in bona fide service agreements with comparable terms at the time of the agreement, where the price or compensation has not been determined in any manner that takes into account the volume or value of anticipated or actual referrals. With respect to rentals and leases described in § 411.357(a), (b), and (l) (as to equipment leases only), “fair market value” means the value of rental property for general commercial purposes (not taking into account its intended use). In the case of a lease of space, this value may not be adjusted to reflect the additional value the prospective lessee or lessor would attribute to the proximity or convenience to the lessor when the lessor is a potential source of patient referrals to the lessee. For purposes of this definition, a rental payment does not take into account intended use if it takes into account costs incurred by the lessor in developing or upgrading the property or maintaining the property or its improvements.”

[24] Commercial reasonableness is a standard that is separate and distinct from FMV. This standard is relevant for both transactions and professional service agreements. Both the U.S. Department of Health and Human Services and the Stark Law have provided guidance for understanding the commercially reasonable standard and it is cited in various Stark Law exceptions and federal Anti-Kickback Statute safe harbor regulations. In 1998, the Centers for Medicare & Medicaid Services (CMS) interpreted commercially reasonable “to mean that an arrangement appears to be a sensible, prudent business agreement, from the perspective of the particular parties involved, even in the absence of any potential referrals." Later, in the preamble to the Stark Phase II interim final rule, CMS gave a definition to commercially reasonable as "an arrangement will be considered 'commercially reasonable' in the absence of referrals if the arrangement would make commercial sense if entered into by a reasonable entity of similar type and size and a reasonable physician (or family member or group practice) of similar scope and specialty, even if there were no potential designated health services ("DHS") referrals."
With respect to management contracts, the Office of Inspector General has indicated that “the aggregate services contracted for do not exceed those which are reasonably necessary to accomplish the commercially reasonable business purpose of the service.”

[25] *See* Bodnar, *supra* note 15.

[26] Mugford, John, *Four Ways the HTA-Duke Realty Deal Changes the Industry,* HEALTHCARE REAL ESTATE INSIGHTS (June 2017).