

Chapter 16

Non-Residential Ground Leases

Introduction

This chapter is limited to the subject of non-residential CLT ground leases – and does not address the much broader, more various and complicated subject of planning, financing and carrying out commercial or other possible economic development projects. For CLTs that are in fact planning non-residential projects, this chapter is intended to guide the drafting of appropriate lease provisions. Because such projects may involve a wide variety of situations, the chapter will not offer a model lease for any one non-residential use or purpose. Instead, it will outline some of the possible non-residential situations that a CLT may want to address, and will note the basic considerations involved in establishing lease terms for the more likely possibilities.

It should be emphasized that some of the more common non-residential uses of CLT property may *not* involve a ground lease – that is, they may not involve the kind of ownership arrangement established by a long-term land lease that provides for lessee-ownership of the improvements. Some CLT's, for instance, make facilities available to nonprofit or for-profit entities through arrangements whereby the CLT retains ownership of the improvements as well as the land and leases the whole property, perhaps on a year-to-year basis. Others make undeveloped land available for use as community gardens, either leased directly to the gardeners on a year-to-year basis or to a nonprofit organization or association that will sublease plots to gardeners. Short-term lessees such as these do not have the opportunity to build equity in the property in the way that a CLT homeowner does, but this aspect of ownership may not be important to those who simply want access to a place to carry out a certain kind of activity. Our emphasis will be on situations where a long-term ground lease does give the lessee ownership of improvements and an opportunity to build equity, but, in some of these situations, we will acknowledge that the CLT must decide whether it can better pursue its mission through such a ground lease or through a more conventional leasing of both land and improvements.

For those who do want a model for a non-residential CLT ground lease, the model residential CLT lease that appears in Chapter 11-A can be adapted. Most sections of the residential model will need only limited adaptation, as suggested in the outline at the end of the chapter. There are several articles, however, that may need to be substantially altered. In particular, we will look at the considerations involved in drafting the following articles.

- The article dealing with land use restrictions and requirements (Article 4 in the residential model).
- The article dealing with rights and responsibilities regarding lessee-owned improvements (Article 7 in the residential model).
- The article dealing with transfer restrictions (Article 10 in the residential model).

For each of these three articles, we will look at the considerations involved in drafting provisions for four basic types of land use.

- use for commercial purposes (retail stores in particular),
- use for processing raw materials or manufacturing,

- use for office facilities,
- use for agriculture.

In every one of these use categories, numerous variations are possible, potentially involving quite different purposes and therefore quite different lease arrangements. We will note some, but not all, of these possible variations.

Leases for Commercial Use

CLTs may have various purposes – or combinations of purposes – in leasing land for commercial use. Possible purposes include the following.

- Creating or supporting small business opportunities for community residents.
- Creating jobs, and/or job-training opportunities for community residents.
- Making needed products or services available to community residents.
- Ensuring that certain activities will not have harmful effects on the community or the environment.
- Making use of space that is not appropriate for residential use in otherwise residential developments.

Use restrictions and requirements. If the primary purpose of a project is to create small business opportunities or jobs, a CLT will probably not want to establish tight use restrictions. In such cases a CLT might limit the use to retail operations, but might be open to whatever type of retail operation would bring the greatest economic benefits for local owners and/or workers, so it might not want to limit sales to particular types of products. If, on the other hand, a CLT is most concerned with the community's access to certain kinds of products (e.g., groceries), it may want to limit a lessee's retail business to those kinds of products – or at least require that it offer those products regardless of whatever else it might sell. If commercial space is located in or near residential buildings, the CLT may also be concerned with the appropriateness of the goods sold for a residential environment that will include children.

“Resident ownership” is also likely to be a concern, just as owner-occupancy is a concern with CLT residential ground leases. If the goal is to encourage local ownership of small businesses, a CLT may want to prohibit “absentee ownership” of a lessee business. But in such cases, CLTs must decide how to define the restriction. Must the owner or owners be residents of the local community? Or is the more important concern not residency as such but the question of whether an owner is a direct, day-to-day, on-site participant in the operation of the business? Or should *both* local residence and direct participation be required?

For most retail businesses, parking is likely to be a significant issue. Is there enough space for customer parking? Will trucks be able to make deliveries without disrupting local traffic? On what parts of the premises should parking be permitted? On what parts should it be prohibited? If a commercial space is located in a residential building, how will parking space be allocated between residential and commercial uses?

Lessee-owned improvements. CLTs must decide how much they want to limit a commercial lessee's ability to invest in permanent improvements to the premises. If the goal is to help low-income people develop their own businesses, the CLT must recognize that the ability of such entrepreneurs to finance a substantial up-front investment will itself be limited. Whereas a low-income homebuyer may be able to borrow \$100,000 or

more to buy a house, a low-income entrepreneur will have access to much less capital. (A number of community development financial institutions do finance small business startups, but the loan amounts are more likely to be \$10,000 than \$100,000.) The CLT must also recognize, first, that the failure rate for small business startups is significant and, secondly, that those that do succeed are likely to outgrow their original quarters – so a significant amount of turnover among startup lessees should be anticipated. For these reasons, a large investment in specialized improvements that may not be useful to subsequent lessees should probably be avoided. There will be an advantage in maintaining a relatively generic storefront facility that can accommodate a variety of retail businesses. In fact there may be reason to avoid lessee-ownership of permanent improvements altogether when dealing with startup businesses. Like the “business incubators” operated by some CDCs, community land trusts that are leasing space to startup commercial enterprises should probably encourage successful lessees not to stay in the “incubator” too long but to make way for others. In such situations building lessee-equity in the improvements is not likely to be a CLT’s goal.

On the other hand if you are less concerned with helping people in the community launch and own their own businesses and are more concerned with bringing investment into the community and creating jobs, you may have reason to allow – and encourage – larger investments in improvements. An existing corporation that wants to open an outlet in your community may be quite capable of buying a building and customizing it to accommodate its commercial needs, and there may be important benefits for the community in having it do so.

With any commercial leasehold, it will be especially important for the lease to distinguish clearly between permanent improvements (owned by the lessee but subject to lease restrictions) and business equipment owned by the lessee and not subject to lease restrictions. (See Chapter 10, “Legal Issues Re. CLT Ownership” for a discussion of what are generally considered permanent improvements, as opposed to “personal property.”)

Transfer restrictions. Transfer restrictions normally address two issues – the question of *whom* improvements and leasehold interest can be transferred to, and the question of the *price* that the seller will be allowed to charge for the improvements and leasehold interest in the land. On the first question, if a CLT is more concerned with local ownership of local businesses than with jobs as such, it may want to allow transfer only to existing residents of the community, although the question of where the transferee is *from* may be less important than whether she will *now* be a permanent resident of the community and whether she will be directly involved in the operation of the business. If, however, the emphasis is on encouraging investment in the community and creating jobs, the CLT will not want the terms of the lease to screen out potential investors from outside the community.

Regarding price restrictions, it is a relatively simple matter to design a resale formula that will allow a commercial lessee to recover the price she initially paid for the improvements, perhaps adjusted for depreciation, and perhaps with an adjustment recognizing inflation, based on either a fixed rate of “interest” or on changes in an index such as the consumer price index. In this respect, designing a resale formula for a commercial property is similar to designing a resale formula for CLT homeownership situations (see Chapter 12, “Resale Formula Design”).

However, commercial lessees are much more likely than residential lessees to need to invest in further improvements to accommodate the evolution and/or expansion of their businesses. It is not a simple matter to decide how much equity the commercial lessee should be allowed to build up through such further investment, or to decide how this equity build-up should be measured. If the CLT wants to encourage ownership of local businesses by local residents, it will need to strike a balance between, on the one hand, establishing a strict limit on equity build-up so that the property will remain affordable for successive lessees, and, on the other hand, allowing prices to increase by amounts reflecting the actual use value that the lessee has added. If the property in question is seen primarily as an “incubator” for small businesses, the CLT will probably lean toward allowing little or no equity build-up in the improvements, but if the goal is to encourage long-term investment in the improvements – as a means of “asset-building” for the lessee, and/or as a means of encouraging the kind of investment that will bring jobs and shopping opportunities to the community – the CLT may lean toward a policy that will allow the resale price to be substantially increased by the lessee’s further investment in improvements.

In the latter case, the question is how to determine the amount of the increase without the process becoming unduly burdensome for both the CLT and the lessee. If the investment is in one or a few substantial bodies of work, each of which has a documented cost and appraisable value, the matter may be treated in the way that major capital improvements are treated in some residential resale formulas (again see Chapter 12). However, if the investment is in a number of smaller improvements scattered over a number of years, and if much of the labor has been provided by the owner, a formula that does not try to itemize the value of each improvement may be preferable. The better approach may be an appraisal-based appreciation-sharing formula that allocates to the lessee some percentage of the increase in overall market value as determined by appraisals at the time of purchase and the time of resale.

It is also possible, of course, not to impose any price restriction and to let the price be determined by the market for the type of improvements in question. That market would itself be limited by the use restrictions established in the lease – which may prohibit what would otherwise be the most profitable use and may therefore reduce the market price.

Leases for Processing or Manufacturing Use

Processing or manufacturing uses can range from activities like cheese-making, among other types of food-processing, to the repair of watches or shoes or automobiles, to the manufacture of better mousetraps or widgets. A CLT’s reasons for leasing land for these uses will cover more or less the same range of possibilities as the possible reasons for leasing to commercial businesses. In fact, processing and retail sales are often combined in small businesses such as restaurants, bakeries and other small food processing enterprises.

Use restrictions and requirements. Lease provisions relating to processing or manufacturing are likely to be more specific than those relating to most retail businesses. A CLT will usually *not* want its lease to specify exactly what products are to be sold in a storefront property, but, in the case of a manufacturing facility, the CLT probably *will* want the lease to state rather specifically what is and is not to be produced on the premises. In entering into such a lease for a specific manufacturing process, the CLT

may be influenced by what products are needed in the community, by what is likely to contribute to the success of the lessee's business, by the potential for job creation, and by the potential effects of the process on the environment (ranging from the effects on local water or air quality, to noise levels, to the "carbon footprint" and its effect on global climate), as well as by the appropriateness of the location and the facility for the process in question.

Permission to carry out the specified processes on the premises should of course be conditioned upon the lessee acquiring any government permits that may be required for the activity and upon compliance with any statutes or codes regulating the activity. And of course appropriate liability insurance covering the activity should be required.

Lessee-owned improvements. Because processing and manufacturing activities are more likely than commercial activities to require specialized improvements, a lease that allows these activities will need to allow the lessee to construct or install any such necessary improvements not already present. A CLT entering into such a lease will be concerned about whether these improvements will commit the facility *permanently* to the one process for which they are installed, and, if so, whether the process can be expected to be both economically viable and appropriate for the community for the long term. In either case – regardless of how tightly the lease restricts future use of the property – the CLT will want to retain the right to pre-approve (or reject) any major alterations or additions to the improvements, so that it can be sure that that the changes are appropriate for the intended use and that they will not interfere with the future affordability or practicality of the property and will not have a harmful effect on the surrounding community.

Transfer restrictions. Since it is likely that a lessee engaged in this kind of business will have made substantial investments in specialized improvements, the CLT will need to give careful attention to the question of how much of this investment she should be able to recover when she sells. Before addressing this question, however, the CLT must decide whether the lease will commit the property to its current use by permitting transfer only to a person or entity that will carry on more or less the same type of business and will therefore make use of the specialized improvements. For instance, if the property is used by a bakery that has installed commercial ovens, can it then be transferred only to another bakery business? If transfer is to be restricted in this way, then it may be appropriate to adopt a resale formula that will allow the seller to recover a substantial part of the value invested in specialized improvements that will now be used by a successor. If such improvements consist of equipment that is purchased and installed at the beginning of (or early in) the term of the lease, then a resale formula may simply allow recovery of the documented original cost of those improvements less depreciation at a stipulated rate. If, on the other hand, the investment consists of a number of smaller improvements scattered over a number of years, then the type of "appraisal-based" formula suggested above for similar situations with commercial businesses may be the better choice.

If transfer is not restricted to buyers who will carry on the type of business currently operated in the facility – or perhaps even if it is so restricted – the CLT may prefer to treat specialized improvements, such as a baker's commercial ovens, as personal property of the lessee, which will mean that the lessee can either remove them when vacating the premises or can sell them in place for whatever price the market will bear. In the latter

case, even if the buyer is also the new ground lessee, the sale of this specialized, “personal property” will be separate from the sale of the “permanent improvements” (the building and other permanent structures) and will not be subject to the CLT’s purchase option. (Again, see Chapter 10, “Legal Issues Re. CLT Ownership,” for a discussion of what are generally considered permanent improvements as opposed to “personal property.”)

Leases for Office Use

Some CLTs lease real estate to other nonprofit organizations for use as office space and related functions, including meetings with customers, clients, patients, trainees, etc. It has been less common for CLTs to lease property to for-profit entities for similar uses, but there may be situations where a CLT has reason to do so, and most of the issues involved are not likely to differ from those that must be addressed in leasing to nonprofits. We should also note that, although CLTs sometimes make office space available through relatively conventional shorter-term leases that do not provide for lessee ownership of improvements, we will concentrate here on the use of long-term ground leases for office space.

The CLT purposes that may be served by such lease arrangements include the following.

- Assisting other not-for-profit organizations by making space available on affordable terms.
- Providing affordable space for entrepreneurial ventures by low-income people, women and minorities within the community.
- Providing appropriate space for training, counseling, medical treatment, or other services that will benefit residents of the community.
- Generating revenue for the CLT.

Use restrictions and requirements. The nature of use requirements or restrictions will depend on the CLT’s purpose in acquiring and/or developing the facility and on the extent to which the facility and its location are suited for one or another specialized use, as well as on the CLT’s concern with generating a certain level of revenue. If the CLT’s purpose is to assist in supporting other nonprofit programs in the community, the use of the facility may be restricted to nonprofit programs, or perhaps to specific *types* of nonprofit programs. If the facility has been developed specifically to facilitate certain services in the community, its use may be restricted to providers of those services, whether nonprofit or for-profit. If the CLT’s operating budget for the facility calls for a significant level of lease fee revenue, and if the facility contains generic office space – suitable for any individual, program or business that needs space in which to locate one or more desks, telephones, computers, etc. – then the CLT may choose to establish only minimal use restrictions. Even in such cases, however, the lease may still require that the lessee make actual use of the space on an ongoing day-to-day basis.

The CLT lease should of course prohibit any use that violates applicable law. And, in any case, the CLT should be mindful of possible specific uses that may be legal but that should not be permitted under the terms of the lease. For instance the cooking of food might be prohibited if appropriate kitchen facilities are not provided. Subleasing – unless the lease explicitly anticipates and accommodates some form of subleasing, as discussed

below – should generally be prohibited or be permitted only with the CLT’s written consent.

Lessee-owned improvements. If a lessee will use an entire building for its offices, then it is appropriate for the lessee to own the building. It may also be appropriate for the lessee to own the building if the lessee will use only a part of the space but is prepared to own, sublease and manage other parts in accordance with the terms of the lease. The terms of the lease may limit the amount of profit that the lessee can realize through such an arrangement but should allow the lessee to recover the costs of managing, as well as owning, the subleased space (see Section 4.5 of the model single family residential lease for language that may be adapted). The alternative to this sort of arrangement is of course for the CLT to retain ownership of the building and lease space directly to multiple tenants.

A lease for office space should normally place strict limits on the lessee’s right to alter or improve lessee-owned improvements without the CLT’s written permission (but should require maintenance of existing improvements). When there is a need for specific alterations or improvements, the CLT will want to work with the lessee to develop appropriate plans for work to be done by or paid for by the lessee-owner.

Transfer restrictions. As is the case with other types of non-residential leases, restrictions regarding who is an eligible transferee will depend on what use restrictions are established. For office space that is not limited to use supporting the provision of specified benefits or services for the community, there may be few explicit limitations on who the improvements can be sold to, though the CLT will probably still want the right to approve or reject proposed transferees. As is true with leases for commercial or manufacturing facilities, if an office facility has been subsidized for the stated purpose of assisting specified disadvantaged or underserved groups such as low-income people, women, or minorities), then it may be necessary, or at least appropriate, to permit transfer only to members of these groups.

CLTs will generally not want to allow substantial alterations or improvements to “generic” office space that would increase the resale price of the improvements. Nonetheless, there are likely to be instances when such changes are in the interest of the CLT and the community and the CLT may therefore allow a “capital improvement credit” to be added to the resale price.

Leases for Agricultural Use

A CLT’s purposes in leasing land for agricultural use may include the following.

- Providing affordable access to land for new farmers.
- Providing access to fresh, locally produced food for local residents.
- Promoting ecologically sound use of local land.
- Protecting open space and preserving a “working landscape” that is seen as an essential part of the community’s identity.

A detailed treatment of the use of ground leases to serve these purposes is provided by Equity Trust, Inc. Equity Trust’s publication *Preserving Farms for Farmers: A Manual for Those Working to Keep Farms Affordable*, which includes case studies, a model agricultural ground lease with commentary, and related materials, can be ordered from the organization’s website (www.equitytrust.org). The model agricultural lease, which is a modified version of ICE’s 2002 Model CLT Ground Lease (to which Equity

Trust holds the copyright) is separately posted on the website. Commentary on that model is also posted. Because these materials are readily available from Equity Trust, we will offer only a general overview of the subject of agricultural ground leases in this chapter. And we will not discuss the many varieties of more conventional farm lease arrangements that involve shorter terms and do not provide for lessee-ownership of improvements.

Use restrictions and requirements. Agricultural ground leases of the sort pioneered by Equity Trust not only permit but *require* a specified level of agricultural use of the land – a provision paralleling the occupancy requirement of CLT residential leases. In addition such leases may establish specific provisions regarding the *type* of agricultural use permitted or required. In some cases, organic farming (by one or another definition) is required. Specific provisions may also be established regarding the different uses of different *parts* of the leased land – in some cases through the attachment of an approved (but potentially amendable) “farm plan” with a map distinguishing tillable areas, areas to be used for grazing, protected riparian areas, forest management areas, etc. There can also be special provisions for a “farmstead” area containing farm buildings and other agricultural improvements – and often residential improvements as well. When a farmhouse is included, there is usually an occupancy requirement similar to that in CLT residential leases.

Lessee-owned improvements. Agricultural improvements that may be owned by a ground lessee include a wide range of items not typically addressed in residential ground leases. These include not only such things as barns, fences and irrigation systems but, in some cases, perennial plantings such as orchards – all of which clearly add lasting value to the land for agricultural use. Development of non-agricultural improvements is usually prohibited or strictly limited, though processing and marketing facilities (e.g., milk-processing/cheese-making facilities, grain milling facilities, farm stands, etc.) may be permitted. Construction of new buildings, even for agricultural purposes, is typically permitted only within specified “building envelopes.” As with CLT residential leases, approval by the ground lessor is typically required for construction of any new buildings, and, in reviewing requests for approval, the lessor is usually directed to consider the future affordability of the improvements for farmers, among other factors.

Transfer restrictions. Transfer is normally permitted only to people approved by the lessor as having demonstrated the intention and the ability to use the property for “commercial” agricultural purposes (the exclusion of “hobby farmers” is intended). Resale price restrictions are designed to keep resale prices affordable for people dependent on farming for their living (admittedly a less precise criterion than the income-based definition of affordability used in affordable housing programs). The resale formulas that may be used include some that are familiar to CLTs, but the most common practice is to define the purchase option price as the *appraised agricultural value* of the improvements. Such appraisals usually employ both the market comparison approach (comparing the property to other farms in the area that have been sold for known prices to buyers intending to use them for agricultural purposes) and the income approach (calculating the present value of the net income that can be generated by use of the property for agriculture). These leases are typically used in real estate markets where the “estate value” of farms, created by demand from affluent non-farmers, far out-strips their

agricultural value. In these situations the appraised *unrestricted* market value can easily be more than twice the appraised as-restricted agricultural value.

Lease Fees and Revenue Generation

In establishing the fees to be charged to non-residential lessees, CLTs will be concerned with balancing the interests of the lessee and the social goals of the arrangement on the one hand, and, on the other hand, the CLT's interest in generating enough revenue to cover the costs of stewardship and perhaps to help service debt arising from the acquisition and/or development of the property. The need for finding such a balance should be addressed in the early stages of planning for the project. If in fact the lease fee cannot be subsidized – or can be subsidized only to a limited extent – then certain purposes, such as helping low-income people start their own businesses, may not be practical.

In most of the situations discussed above, a CLT will want to subsidize lease fees as much as possible – at least during the start-up phase of small businesses, when cash flows can be expected to be lean. In these situations a graduated fee scale – beginning with a very low fee and increasing over time – may make sense. If the lessee is an established business, however, the situation may call for a market-rate fee – both because it will provide more revenue for the CLT and because, for a 501(c)(3) organization, subsidized rent is generally prohibited for a for-profit business if the subsidy does not serve a charitable purpose (such as helping a low-income person start a business). It should be understood, however, that the restrictions and requirements established by a lease can substantially reduce the market value of the leasehold – as in the case of the agricultural leases noted above. This being the case, the lease should provide (as the model residential lease does in section 5.6) for the adjustment of the fee if and when restrictions are eliminated or reduced.

Adapting the Model Residential Ground Lease: an Overview

Though certain modifications will be necessary, the model CLT single-family residential ground lease (Chapter 11-A) can provide a practical framework within which to develop leases for non-residential purposes. In most cases, the majority of the articles in the model residential lease can be utilized in a non-residential lease with little or no modification, as indicated in the following outline (articles are numbered as in the single-family residential lease). The Commentary on the model residential lease (Chapter 11-B) may be helpful in working out adaptations.

1. *Letters of Agreement and Attorney's Acknowledgement.* When the lessee is a corporation rather than one or more individuals, the CLT may omit this requirement (as in the CLT-coop lease presented in Chapter 15).
2. *Leasing of Rights to Land.* This article is applicable for non-residential use.
3. *Term of Lease; Change of Land Owner.* This article is applicable for non-residential use.
4. *Use of Leased Land.* Some sections of this article may be adapted for non-residential use, but specific provisions for non-residential use will need to be drafted, as discussed in this chapter.
5. *Lease Fee.* Most sections are applicable for non-residential use, but different considerations are likely to be involved in determining the amount of the fee, as discussed in this chapter.

6. *Taxes and Assessments.* This article is applicable for non-residential use.
7. *The Improvements.* Some sections of this article may be adapted for non-residential use, but additional provisions may be needed, as discussed in this chapter.
8. *Financing.* Most if not all of the provisions in the residential lease are applicable.
9. *Liability, Insurance, Damage and Destruction, Eminent Domain.* This article is applicable for non-residential use, though specifications for liability insurance may need to be modified.
10. *Transfer of the Improvements.* Some sections may be adapted for non-residential use, but additional considerations are likely, as discussed in this chapter.
11. *Reserved.* Identified as “reserved” in the current version of the residential model, this article can be used to deal with any additional subjects a non-residential lease may need to address.
12. *Default.* This article is applicable for non-residential use.
13. *Mediation and Arbitration.* This article is applicable for non-residential use.
14. *General Provisions.* This article is applicable for non-residential use.