

SALE/LEASEBACK TRANSACTIONS IN REAL ESTATE

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Live Replay: September 29, 2014

1:00 p.m. E.T./12:00 p.m. C.T./11:00 a.m. M.T./10:00 a.m. P.T. **(60 minutes)**

Sale/leasebacks of property are sophisticated real estate transactions where both seller/tenant and investor/landlord can obtain substantial financial, tax and operating benefits. The property owner builds or buys a property it intends to use for its own purposes, sells it to an investor, and then immediately leases it back from the investor for a term of years. Properly structured, the seller/tenant can harvest equity from a building while still using it or finance construction on favorable terms and obtain tax benefits. The investor/landlord can also obtain substantial financial and tax benefits. However, if the transactions are not properly structured, there is a substantial risk of adverse financial and tax consequences, nullifying all economic benefits. This program will provide you with a practical guide to understanding the economics of sale/leaseback transactions, properly structuring these deals, and drafting trips to avoid traps.

- Structuring sale/leaseback transactions in real estate and business
- Reasons for doing a sale/leaseback transaction – tax benefits, liquidity needs, exit strategy for property owner, finance of purchase or construction
- Types of leasebacks – standard/full, partial, short-term, seller-to-vacate
- Practical drafting guidance to avoid common and costly mistakes
- Characterization of transaction as a financing – and financial/tax consequences
- Unwinding sale/leaseback transactions

Speaker:

Richard R. Goldberg is a retired partner, resident in the Philadelphia office of Ballard Spahr, LLP, where he established an extensive real estate practice, including development, financing, leasing, and acquisition. Earlier in his career, he served as vice president and associate general counsel of The Rouse Company for 23 years. He is past president of the American College of Real Estate Lawyers, past chair of the Anglo-American Real Property Institute, and past chair of the International Council of Shopping Centers Law Conference. Mr. Goldberg is currently a Fellow of the American College of Mortgage Attorneys and is a member of the American Law Institute. Mr. Goldberg received his B.A. from Pennsylvania State University and his LL.B. from the University of Maryland School of Law.

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Teleseminar
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Sale Leasebacks and Ground Leases

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1. Why a ground lease and a sale-leaseback
 - a. Landlord– retains control of the real estate; long term income; avoidance of capital gains.
 - b. Tenant – Receive return of cost; potential accounting issues; off balance sheet treatment; favorable rental payments; ability to do leasehold financing
2. Drafting Considerations
 - a. Tenant must be able to act with minimal interference from the Landlord during the course of the lease.
 - b. Tenant must be able to finance the construction and permanent leasehold.
 - c. Tenant must be able to obtain proper consents, recognition and non-disturbance from the Landlord.
 - d. Tenant must be able to obtain land use approvals with Landlord cooperation.
 - e. Landlord must have major change options such as land use and encumbrances unrelated to the Tenant’s principal business.
 - f. Landlord must have the ability to finance the fee subject to the superior right of the leasehold mortgagee.
 - g. Landlord should be prepared to facilitate the rights of the Tenant.
 - h. The parties should consult tax counsel to make sure that proper tax treatment is given to their respective objectives.
 - i. Rent setting provisions are most important. Most sale leaseback transactions are for many years. In those cases, the typical rent reset is done by appraisal. In shorter term situations, either fixed increases are appropriate or indexes such as a version of the CPI are employed. One must be careful since the selected index may not exist in the future. In the case of certain commercial uses, the parties may employ a participating rent which is normally based on gross revenues but can take into consideration certain net features.
3. Financing by the Tenant
 - a. The ground lease must contain a number of provisions in order to make the ground lease eligible for leasehold financing
 - b. The term must be sufficient so that the leasehold lender has an exit strategy. For example, if the Tenant is seeking a 20 year mortgage, the remaining term of the

ground lease should be at least 30 years. This allows the Tenant to obtain take out leasehold financing. The Tenant must consider the remaining term of the ground lease and negotiate for length of term that will permit serial refinancings.

- c. Any Landlord purchase option should take into consideration the possibility that leasehold financing will require pre-payment of existing financing and must discuss responsibility for any pre-payment premium.
 - d. The rights of the Landlord must be subordinate to the rights of the Lender/
 - e. Fee simple financing should be required to recognize the existence of leasehold financing and agree that the fee lender will not foreclose out the rights of any leasehold lender or the Tenant.
 - f. The fee lender should be required in the event of foreclosure, bankruptcy or sale of the fee position and termination of the ground lease to give the Tenant or its lender a new lease on the same terms and conditions and for the same rental and remaining term as the terminated lease. This should be in the lease and also be incorporated in a separate agreement.
4. Unwinding the sale-leaseback transaction.
- a. Most sale-leaseback transactions have alternate provisions at the termination of the lease.
 - b. The most common is a fair market value purchase option vested in the Tenant at the termination of the term or each option.
 - c. Most Landlords bargain for the right to own the improvements at the end of the term of the lease. One can require demolition and the restoration of the property to as close to possible to its original condition. Bear in mind that certain encumbrances will remain and the Landlord needs to contemplate how to deal with this issue.
 - d. If the building is to remain, the condition of the improvements on termination are subject to negotiation but typically requires that the property be put in broom clean condition subject to normal wear and tear.
 - e. There can be terms which require Landlord contribution to improvements based on an increased rental return.
5. Accounting issues.
- a. One of the most significant uses of sale leaseback transaction resulted in the creation of an operating lease for accounting purposes. There are presently two forms of lease for accounting purposes: capital leases which have to be placed on the Tenant's balance sheet as an asset with accompanying liability and depreciation recognition. The other is an operating lease which requires no

balance sheet treatment and depreciation recognition. Most leases are structured as operating leases which have distinct terms and certain features including mandatory fair market value purchase options and other operating characteristics.

- b. The European Union accounting community has abolished this distinction and has placed considerable pressure on the US Financial Accounting Standards Board (FASB) to follow suit. The net result of the change is that the sale leaseback will be treated as a financing on the balance sheet of the Tenant with the cost of the improvement recognized as an asset and the transaction will appear as a loan on the liability side. Instead of rent as an expense, the income and expense statement will reflect interest and depreciation as the expense which will likely exceed the rental cost.
- c. There has been back and forth discussion among the accounting community and various real estate interests as to whether or not these changes are efficacious.
- d. As of this time, the new accounting rules have not been adopted. However, it appears that adoption is approaching. This will drastically alter the playing field for a significant number of sale leaseback transactions. The principal rationale for many sale leaseback transactions is to avoid balance sheet implications. These transactions will likely not be done with any frequency unless the economics are altered to realign the costs of the transaction under the new rules with that of the old rules.
- e. None the less, there are still many transactions where a sale leaseback or ground lease transaction will be beneficial to both parties. The transaction will not become extinct although there are some who predict that it could become an "endangered species".