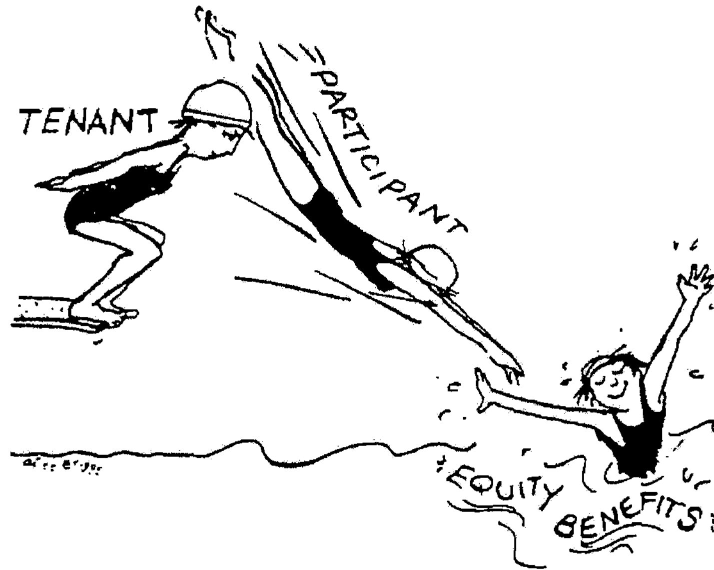
The potential rewards are substantial for those willing to take the risk.

Financing Real Estate Development Through Participation Leases

Alan M. Di Sciullo and John B. Wood



IN NORMAL TIMES, landlords are reluctant to allow tenants to participate in the profits or cash flow of a building or shopping center. They believe these to be just rewards for the risk that they have taken in developing, constructing, and financing their property. Fortunately for tenants, these are not normal times. Overbuilding, higher-than-usual vacancy rates, and a sluggish economy have made owners look for ways to attract tenants and to maintain rental rates. In addition to rental concessions and building allowances, some landlords are willing to give equity or other participation rights to creditworthy tenants in order to induce them to lease large blocks of space.

HOW PARTICIPATION LEASES WORK

A participation lease permits a tenant to share (or participate) in a real estate project's equity benefits. For example, in exchange for paying a higher-than-market base rental or agreeing to a longer lease term, a participation lease allows the tenant to receive participation in the project's profits. Usually, the participation is an interest either in the property's operating cash flow or in its appreciation. In some arrangements, the tenant may also receive an interest in the project's tax benefits. Tax benefits usually consist of depreciation and interest deductions and a share of any applicable tax credits. The cost and distribution of these benefits is a function of each party's relative bargaining strength, of the advantages that each party perceives in the deal and of the parties' belief in the likelihood that the equity objectives will be attained.

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The arrangement naturally increases the tenant's leasing risk and the landlord's ownership risk; it also further complicates the basic leasing transaction. Landlords give up the potential cash flow, tax benefits, and/or appreciation that may cushion their risk-taking activity, while tenants risk realizing little or none of the expected value for which they have bargained. The cost of the equity participation to the tenant is the forfeiture of substantial benefits at the commencement of the leasehold, including work allowances, rental adjustments, or favorable renewal rights.

Working With the Numbers: An Example

An example readily shows how a participation agreement works, Oakdale Partnership is constructing a 100,000-square-foot building on a large parcel that it owns. Acorn Computer Company has outgrown the space that it currently occupies in its own building. Because Acorn is a highly desirable corporate tenant, it can demand a below-market rental rate, liberal rent abatements, and considerable work concessions if it were seeking a normal lease deal. Oakdale approaches Acorn with the following proposal: Oakdale will build to suit the 100,000 square feet that Acorn needs if Acorn agrees to pay an above-market rent without concessions under a triple net lease. At the same time, by means of a like-kind exchange Acorn will swap its existing inadequate building for a 50 percent interest in the facility Oakdale is building for Acorn. During the transition period before Acorn can move into the new property, it will lease back its old building from Oakdale at a rental equivalent to the building's carry (more accurately, at triple net without profit). Acorn also obtains an option to purchase the remaining 50 percent of the new building at its fair market value either in increments over the years or at one time in the future.

The implications of these various arrangements can be demonstrated by the use of hypothetical (but fairly accurate) numbers. Had Acorn merely rented the new building, it could have negotiated a base rent of approximately $25 per square foot annually plus about $5 per square foot for the initial year's real estate taxes and operating expenses. Acorn probably would have received three months' free rent and a premium work letter that would be sufficient to cover leasehold improvement costs. Over a five-year term, assuming annual escalations of $1 per square foot and considering all concessions, Acorn's blended rent would be approximately $26 per square foot annually. For tax purposes, Acorn would have a $26-per-square-foot annual deduction from revenues but no depreciation deduction.

Under the equity participation lease previously described, the blended base rent would be approximately $30 per square foot annually. Acorn would receive a standard work letter and a small construction abatement. As in the space lease, escalations (taxes and operating expenses) would rise by $1 yearly to average $7 per square foot annually. This scenario means that Acorn would make annual payments of $35 per square foot. However, Acorn has a 50 percent ownership position in the building. The building's rental receipts are approximately $30 per square foot (net of direct payment for taxes). Since the building pays about $20 per square foot annually for debt service, approximately $10 per square foot is available to be divided between equity participants. The partnership that owns the building can depreciate the leasehold improvements and the building, thereby sheltering most if not all of the $10 per square foot of annual profit.

Consequently, Acorn is able to deduct annually from taxable income rental payments of approximately $35 per square foot, but it has a tax-free recapture of approximately $5 per square foot. The various write-offs in the participation arrangement more than offset the higher effective rent that Acorn pays, even assuming that it pays a relatively low marginal corporate tax rate of 20 percent. Additionally, Acorn participates, on a tax-deferred basis, in 50 percent of the project's value as it has been enhanced by the triple net lease of a highly creditworthy tenant, itself. Thus, Acorn is leveraging its income by its own leasehold obligation and participating in a first-class project enhanced by its own presence. Exhibit 1 is a tabular presentation of the comparative costs and benefits of Acorn's lease alternatives.

Landlord Benefits

The example above also demonstrates the benefits that persuade the landlord to relinquish some of its equity interest to a tenant. In a tenant's market, offering a participation is one way landlords attract large, long-term, quality tenants. It enables the landlord to extract above-market rentals and to obtain better financing because he can show a lender a major tenant and higher-than-average cash flow. The above-market rentals and equity participation also enable the landlord to reduce carrying costs. Finally, the equity participation lease with an attractive anchor or major space tenant enhances the landlord's ability to attract other tenants. Thus, despite the concessions that a participation lease involves, ultimately it may strengthen long-term cash flow.[1]

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[1] Paul Giannone and William Platter. "Tenant

EXHIBIT 1
ALTERNATIVE LEASE ARRANGEMENTS BETWEEN OAKDALE PARTNERSHIP AND ACORN COMPUTER CORPORATION
(dollar figures are per square foot)

		Standard Market-Rate Lease	*Participating Lease*
(1)	Base rent	$25	$30
(2)	Average O&E	$ 7	$ 7
(3)	Work allowance	$25	$10
(4)	Abatement	3 months	1 month
(5)	Deductible rent expense*	$25.50	$34.40
16)	Deductible interest expense	0	$20.00
(7)	Total tax benefits (Lines [5 + 6] x 20%)	$5.10	$10.90
(8)	Effective after-tax cost (Lines [1 + 2] - line 7)	$20.40	$23.50
(9)	Profits	0	$ 5.00
(10)	Effective net rental	$20.40	$18.50

*Deductible rent expense in line 5 is the average annual base rent and O&E taking into effect the work allowances and abatements in lines 3 and 4.

In addition, the participation deal may make possible many short-term benefits for the landlord. The landlord can usually better leverage the project because the higher rents cause traditional capitalization and cash flow methods to yield a much greater financial package. It also permits him to defer initial, upfront construction allowances, rent discounts, and other concessions common in a lease transaction Additionally, the participation transaction assures the tenant's interest in the project and its overall success.[2]

Tenant Benefits

Equity participation arrangements enable the tenant to reduce the premium rent that it pays by using depreciation and other tax deductions.[3] Because equity arrangements usually involve a longer lease term than is common for standard leases, equity tenants enjoy the stability of long-term rates that ultimately are less than the average rates experienced by tenants who enter the marketplace periodically. An ownership interest also gives a tenant control of management costs and activities that is not available to pure space-users.

Thus, the tenant should view the equity participation as a way of reducing long-term rental costs. The tenant benefits lost by giving up initial concessions or lower rates will be made up by participation in the property's cash flow, the proceeds from a sale or refinancing, and an apportionment of tax benefits attending ownership.[4] Even if these expected benefits are never realized, participation may produce benefits that do not exist in a pure lease deal if the tenant's projections for cash flow and appreciation are realized.

The effect of appreciation on the numbers of the deal examined above can readily be shown. Assume that the building has an original basis of $20 million and appreciates at a conservative 5 percent per year after Acorn takes occupancy. The building's annual appreciation increases from $1 million ($10 per square foot) in the first year. Acorn's 50 percent ownership means that it earns an amount that starts at $5 per square foot in tax-deferred appreciation annually, which it can realize at any time by mortgaging its property interests. When Acorn acts on its option to obtain the second 50 percent of the project, it will obtain all $10 per square foot of annual appreciation. Should it be holding a fixed-price option (not entirely unusual for a triple net lease tenant), it will have captured the building's entire appreciation.

As already indicated, equity ownership is always accompanied by risk. Anticipated market changes are not always realized. Legal changes and shifts in financing availability may occur unexpectedly. If all or a portion of an equity benefit is triggered ten or fifteen years from lease commencement, unanticipated tax law changes may seriously affect the tenant's depreciation benefits, and unexpected market conditions may affect the equity participant's cash flow benefits and the amount it can finance.

STRUCTURING AN EQUITY PARTICIPATION

Of the several ways to structure a participation agreement, the following are the most common:

- Joint ventures;
- Phantom equity arrangements:
- Condominiums;
- Tenants-in-common agreements; and
- Special leases.

Equity Participation Agreements." *Real Estate Finance 2* (Summer 1985): ____.

[2] Ibid.

[3] Richard A. Goldberg. "Tenant Equity Participation." ALI-ABA Course of Study. Advanced Issues in Commercial Real Estate Leasing (1984).

[4] Menachem Rosenberg, "Equity Leases: Structuring Tenant-Developer Joint Ventures." *Real Estate Review* 15 (Winter 1988): 54.

Joint Venture and Lease

The most common participation arrangement is a joint venture in which the parties create a general or limited partnership and execute a lease that is independent of the partnership but that is economically keyed into the participation vehicle.[5] The type of joint venture structure and the nature of the tenant's equity contribution depend on when in the development process the tenant joins the project. If the tenant joins the project at an early stage (before construction and permanent-financing plans are completed), the tenant may be able to acquire its interest merely by paying the rent premium but with negligible initial cash investment. With this arrangement, however, the tenant risks the possibility that the Internal Revenue Service may recharacterize the agreed-on higher rents as capital contributions to the venture, thereby eliminating the deductibility of the above-market portion of rent expense.[6]

The tax rules seem to dictate that the tenant must make an appropriate equity contribution to the joint venture in exchange for its interest in the property. However, the tenant may not have to make a contribution if it can show that, due to development problems (e.g., construction overruns, financing cost increases, carrying costs, and a slow leasing process), market rents give the project no incremental value over the amount of developer or third-party borrowings.

The partnership agreement must be carefully written. Special allocations that disproportionately allocate tax benefits to joint venture partners will be construed as having "substantial economic effect" within the meaning of current tax laws and IRS guidelines. The agreement should address the possibility that the property may be sold before the lease term expires. Such a sale would cause the tenant to lose expected tax benefits and cash flow, effectively increasing its rental costs for the lease period. One solution is to compute the present value of the tenant's expected tax and cash flow benefits and to specify that any shortfall between expected and actual benefits will be added to the funds distributed to the tenant at the time of sale.

Phantom Equity Arrangements

A "phantom" or "soft" equity arrangement is an agreement that gives the tenant a claim to the property's future appreciation. The tenant does not obtain any tax benefits or receive any part of the operating cash flows. The soft equity arrangement avoids the possibility that the tenant will be required to fund operating deficits and potential equity accounting problems. The tenant's share of property appreciation can be distributed upon property sale, after an appraisal, upon lease expiration, or at another specifically agreed-on date.

The phantom equity arrangement assumes that the property's value will appreciate faster than the rent roll; that is, that operating income will be capitalized at a lower rate in the sale year than in the year of the original agreement. Exhibit 2 is the numerical calculation of a hypothetical equity deal. The tenant receives 50 percent of the net profit when the building is sold. The agreement assumes that the appropriate original cap rate is 9 percent and the appropriate capitalization rate in the sale year is 8 percent. The tenant is entitled to 50 percent of the appreciation arising from the change in cap rates.

The Exhibit 2 calculation gives the owner the profit derived from the NOI and from the owner's entrepreneurial and managerial efforts. However, the calculations assume that improving markets have reduced cap rates, a change that of itself increases the property's value. The agreement gives the tenant 50 percent of' this increase.

The tenant's risks in a phantom equity deal parallel those in a joint venture agreement. Poor management will inhibit both adequate cash flow growth and a decline in the capitalization rate needed to increase a building's value as a multiple of its cash flow. Consequently, the tenant will not derive any benefit from the agreement since it had relinquished any rights to tax-shield and operating-income benefits.

Phantom equity deals work best in established buildings run by financially sound firms. Owners tend to favor the phantom arrangements over the joint venture because they limit the tenant's share in the property's accumulated appreciation.

Condominiums

A condominium arrangement gives the tenant ownership of all or part of its premises. The tenant pays for the condominium unit and shares in its operating costs. In turn, the tenant is entitled to the unit's depreciation, and the tenant receives any later appreciation that accrues to the condominium when it is sold or leased.

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[5] Goldberg. "Tenant Equity Participation."

[6] Giannono and Platter. "Tenant Equity Participation Agreements"

EXHIBIT 2
HYPOTHETICAL PHANTOM EQUITY ARRANGEMENT

(1)	Building sale price	$40,000,000
(2)	Year-of-sale net operating income	3,500,000
(3)	Year-of-sale capitalization rate	8%
Owner's Priority Share		
(4)	Net operating income (NOI)	$ 3,500,000
(5)	Cap rate at time of agreement	9%
(6)	Resulting value	$38,888,889
Excess Proceeds Distribution		
(7)	Excess proceeds	$1,111,111
(8)	Tenant's share (50%)	$ 555,556

Condominium arrangements are often motivated by tax considerations. Regulations established pursuant to Section 704 of the Internal Revenue Code limit a limited partnership's (owner's) ability to allocate losses to a major limited partner without the partnership's giving the limited partner (the tenant) an equivalent interest in the cash flow and residuals unless the tenant agrees that, upon liquidation of the partnership, it will contribute cash to restore any deficit in its capital accounts.[7] As a result, some landlord/tenant equity deals merely give the tenant fee simple ownership of a condominium interest. The tenant, rather than taking on liability for third-party financing, acquires a condominium unit in the building in exchange for its execution of a purchase money mortgage note with personal liability.[8] The tenant's debt payments are structured to provide both parties with cash and tax benefits that are similar to those obtained from a limited partnership.

Tenants-in-Common Agreements

The tenants-in-common arrangement is an appropriate way of dividing project ownership of a project in which construction is substantially complete and financing is in place. The owner transfers to the tenant, by fee simple deed, that portion of the project that constitutes the tenant's ownership position. The arrangement also provides a great amount of flexibility in determining whether the tenant's interest will be encumbered by existing or future financing. These issues can be best handled in a tenants-in-common agreement that resembles a joint venture agreement recorded against the land. Consideration should also be given to using a financeable ground lease, as such a lease affords considerable flexibility in allocating or limiting depreciation, tax benefits, and long-term appreciation.

Special Leases

A little-used participation vehicle is the special lease. Under the terms of this lease, the tenant's annual rent payments will be reduced by some amount related to project return. In this respect, the project earnings are like a dividend or insurance premium in which the annual payment is reduced in the year benefits are received.

The main drawbacks to the tenant with special leases are that it receives neither ownership nor tax benefits. However, if the project is profitable, the tenant will realize lower effective rents.

ENVIRONMENTAL CONCERNS

Equity participation partners should be aware of their potential liability under the Federal Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA) and the other various federal and state environmental laws. CERCLA imposes strict liability upon current facility owners or operators. Furthermore, the courts have interpreted liability of these parties in very broad terms in order to achieve CERCLA's legislative purpose of clearing land and buildings of hazardous wastes. As a joint venture partner or other equity owner, a tenant may be a potentially responsible party (PRP). Under the law, a PRP is liable for environmental clean-up costs and penalties resulting from the presence of hazardous wastes or substances on the property. The courts have interpreted CERCLA to impose strict liability upon all PRPs subject only to limited stated defenses. These courts have consistently held that defendants under CERCLA are jointly and severally liable where the harm at a particular site is indivisible. Once categorized as a PRP, a participating tenant may find itself with full and complete liability for damages, especially when it is difficult to apportion same. As a result, equity participants rarely escape liability.

A tenant may raise the "innocent landowner defense" if he "did not know and had no reason to know" that hazardous substances were present after undertaking all appropriate inquiry.[9] This defense is available to a defendant who acquired an interest in the property after the disposal of hazardous substances and who is able to prove that a third party was solely responsible for the release of these wastes.[10] Case law on this point is still unclear as to

[7] Lewis R. Kaster, "Tax and Securities Implications of Tenant Equity Participants." *Real Estate Review* 19 (Spring 1989): 38.

[8] Ibid.

[9] 42 U.S.C. § 9601 (35)(A)(B).

[10] United States v. Monsanto, 858 F.2d. 160 (4th Cir. 1988), *cert. denied,* 109 S.Ct. 3156 (1989); Washington v. Time Oil Co . 68th F. Supp. 529 (W.D. Wash. 1988).

whether the innocent landowner defense applies only to purchasers who become owners or to lessees and others who become operators and take an interest in the property. The language in the statute is ambiguous at best, and the legislative history is inadequate to dispose of conflict. Consequently, the issue may well have to be resolved by litigation or further legislative amendment.[11]

Therefore, tenants entering into an equity participation agreement should examine the building or project site and assure themselves that the building or property in which they are participating is environmentally safe and clear of any potentially hazardous waste. Along with representations in the joint venture or limited partnership agreement from the landlord that the building and property are free from hazardous waste or substances, the tenant should conduct its own environmental and engineering studies to determine that the project meets federal and state environmental standards so that the tenant will not later be drawn into an environmentally related lawsuit.[12]

CONCLUSION

Equity participation by tenants has become part of landlord/tenant lease negotiations. In return for agreeing to a higher initial base rent, a tenant can receive tax benefits and a share in the project's appreciation. The landlord assures itself of a creditworthy tenant and therefore will likely be able to leverage itself better because of the higher rental stream.

Tax, market, and environmental considerations, however, may reduce or eliminate the tenant benefits. Because of the integrated nature of the equity and lease relationship, a tenant may find its investment to be relatively illiquid. The tenant risks the possibility that it may outgrow its premises. In that event, although the tenant has a worthwhile investment, the long-term lease is no longer an asset for its business. Since the worth of the equity investment is intrinsically tied to the leasehold's value, retaining adequate expansion rights is essential to preserving the value of the equity arrangement.

Tax problems may arise if the transaction is prematurely terminated. The tenant may face severe problems of income recapture after an early cancellation or other unforeseen termination of the transaction. Accordingly, any participation deal should consider the impact of early dissolution and the value of the partnership assets at such time.

Other potential problems are that the IRS may view the tenant's premium rental payments as nondeductible capital contributions, or the venture may not realize its expected gain because the project fails to appreciate as much as originally expected. Finally, environmental difficulties may draw both tenant and owner into expensive and time-consuming litigation, with potential clean-up damages well in excess of the project's expected benefits.

Despite the pitfalls and drawbacks, a properly designed equity participation arrangement offers long-term benefits to a corporate tenant. Although current market conditions now hamper speculative development, they may increase the demand for build-to-suit projects that offer equity participation to lead tenants.[13] The arrangement obviously is more advantageous for a corporation's large regional office or headquarters, with its greater economies of scale, than for its small branch. The absolute return obtainable, with respect to profits and financing, is also much greater for larger projects. Finally, because branch managers' compensation is often tied to current returns, few managers have the patience to support a strategy that offers long-term benefits at the cost of higher near-term rents.

Although participation arrangements offer immense rewards, especially in a rising real estate market, they can be risky for both landlord and tenant. Each party should have competent tax and real estate counsel. Each should also conduct the thorough financial analysis and engineering and environmental studies needed to assure that its expectations are realistic and that the project will bear no unpleasant surprises.

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[11] See D. Vanney, *Real Estate Transactions and Environmental Risks: A Practical Guide* (Executive Enterprises, Inc., 1990) at 22-28, for a discussion of the application of the innocent landowner defense to lessees and other parties.

[12] Tenants who wish more information on the subject of potential liability under CERCLA will find helpful the following articles that have recently appeared in this journal: Ronald G. Todd, "Handling Environmental Law Concerns in Real Estate Transactions." *Real Estate Review* 19 (Spring 1989): 76; Hugh O. Nourse and James S. Treischman, "Managing the Risk of Environmental Liability." *Real Estate Review* 20 (Spring 1990): 84.

[13] Steve Bergsman, "Build-to-Suits: More Tenants Taking Equity." *National Real Estate Investor* (April 1990): 98.