Leveraging Air Rights to Finance Construction

James P. Cullen and Lawrence J. Bartelemucci

James P. Cullen is a shareholder and Lawrence J. Bartelemucci is an attorney at Anderson Kill & Olick, P.C. in New York, NY. They may be reached at jcullen@andersonkill.com *and* lbartelemucci@andersonkill.com, *respectively.*

As the amount of available land on which to build decreases, landowners and developers often find themselves searching for new and innovative ways to maximize the value of their properties. It is ironic, then, that one of the most innovative, yet underutilized methods of maximizing land value is not new at all. For over 35 years, the New York City Educational Construction Fund (ECF) has maximized the value of many New York City sites by simply leveraging the value of the air rights over those sites to fund the construction of city schools as part of combined-occupancy structures.

In the ECF model, ECF issues a long-term lease to a developer for an "envelope of space" above a site that it owns or was conveyed to it by the City of New York. The developer then funds and constructs the non-school portion of the building within that envelope of space, while paying rent to ECF over the typical 75-year term of the lease. Non-school uses for ECF projects have included a large office building, a communications technology facility and both luxury and subsidized housing. ECF then utilizes the rental income received from the developer to secure the financing for the construction of the school portion of the combined-occupancy structure. The developer is also responsible for the actual construction of the school portion, based on approved plans and an agreed price.

PAYING CONSTRUCTION DEBT

Once financing is secured and the building complete, the rental income from the non-school portion is used to pay off the construction debt for the school portion. At the end of the non-school portion lease, the envelope of space and existing building become the property of the landowner. In some cases, the rental value of the air space exceeds the debt service for construction of the school. In other cases, the rental income is less than the debt service for the school construction cost, and surplus from another ECF project can be utilized to make up the shortfall or the city can cover the shortfall in its lease of the school. Any rent paid by the city for the school will be far less than the cost the city would have incurred to build the school itself. The school lease extends for the term of the school construction bonds, which have a 40-year amortization period.

This arrangement creates a win-win situation for both the landowner and developer. The landowner in ECF's position obtains its space at much less cost than if it was constructed as a free-standing structure, and may even obtain it at no net cost. Moreover, the leasing of the air rights allows the landowner to tap an income source that would otherwise not be available, and the developer avoids the up-front cost of land acquisition (which often comprises twenty to twenty-five percent of development costs). This 20 to 25 percent savings of early

development costs can be essential to developers, as financing is normally difficult to obtain or may not be available for land acquisition. In addition, the developer often has a relationship with the general contractor selected to build both portions of the combined occupancy structure, and can derive additional income from the construction profit center.

LOCATION IS KEY

The key to success, as in all real estate transactions, is the presence of valuable property in a desirable location. Local zoning laws must allow for mixed use buildings that enable the landowner and developer to "share" the real property.

The ECF model not only works well for municipalities or quasi-governmental organizations, but it can also work equally well for institutional owners, such as hospitals, universities and other not-for-profit organizations that are not developers themselves. Oftentimes, institutional owners can deliver attractive target tenant prospects for the leased portion of the structure. For example, doctors seeking medical office space on hospital-owned sites and research and development organizations that desire access to universities are ideal target tenants for developers of combined-occupancy structures.

This model allows such organizations increased flexibility and leverage to secure project financing. In addition, a landowner with multiple sites of varying attractiveness can pool the income from its more valuable sites to support those that are in less desirable locations.