The Land Tenure Balancing Scale

The following summarizes a concept presented to the Ag Coalition in June 2002 to stimulate discussion and further the understanding between landowners/lessors and farmers/lessees with respect to how each should expect to balance their respective needs and interests in negotiating a land lease.

There is no perfect science to negotiating a ground lease. It is a contract between two parties which both must feel strikes an equitable balance with respect to issues important to each. If no balance, then probably no “fair deal”.

In many respects it helps to understand a landowner’s/lessor’s perspective by recognizing that a land lease is essentially a loaning of land (a “land loan”) very similar to a bank’s loaning of money (a “bank loan”). There are many similarities as to how a landowner/lessor and banker/lender view their situations, motivations and issues, for example:

1. They both own/have an asset which they need to put to work to generate a return. For the landowner it’s land; for the banker it’s money;
2. They both have choices as to what they can do to earn a return on their asset;
3. They both are subject to the dynamics of the marketplace (i.e. supply/demand);
4. The rates of return they can expect to earn are variable (but more so for bankers).
5. They like to be able to periodically reassess how, where, and to whom their asset has been loaned;
6. They will loan their asset for more favorable terms to a borrower with good credit and track record, good business plan, lots of equity, cash flow, larger is better, diverse income base (i.e. bankers love loaning to borrowers who don’t really need it!);
7. They both operate in heavily regulated businesses --- and bristle at more government regulations.

There are also some important differences between a Lessor and a Lender, such as:

- The cost of their asset is different. (Many large landowners have a low cost basis so they can be more patient “lenders”).
- Many large landowners in Hawaii are also farmers or ranchers, so they understand well the Lessee/borrower’s issues.
c. A landowner, perhaps far more than a banker, can devise ways to “participate” in the transaction more like a partner with the land user by absorbing certain costs, being more flexible on certain lease terms, etc. (Bankers are more strictly regulated in their lending practices.)

To illustrate how the Lessor and Lessee must ultimately strike that “right balance”, the concept of a land tenure balancing scale was graphically presented. The graphic is intended to depict an imaginary “balancing scale”. Unlike the kind of scale you find in a doctor’s office that has a single weight that slides left and right along a single bar until it finds the balance point, this scale has multiple bars; in this model 14 bars to be exact. There could be more or less, but visualize each bar having a weight on it that could slide right or left independent of the other bars. The objective of the “scale”, however, is still the same, to find the balance point (i.e. that right combination of give-and-take in the negotiation process between lessor and lessee that results in what both consider a “Fair Deal”). The weights on the left side have to equal the weights on the right side for the scale to be “on balance”.

Some of the 14 issue bars near the top of the scale represent factual matters that are known to both parties going into the negotiation (i.e. acres proposed to be leased, probable environmental risks that could result from the lessee’s use of the property, anticipated impacts on surrounding lands, etc.). The issue bars at the bottom are clearly points to be negotiated (i.e. terms of the lease, base rent per acre, known rent period, possibly restrictive covenants, etc.). Finally, some of the issue bars in the middle may be either negotiable or matters of fact. It depends on the circumstances (i.e. who has to make what kinds of investments/improvements to make the deal work, what residual benefits will be left to the lessor upon termination of the lease, etc.). There could also be other issue bars.

There is no magic formula as to how the negotiations are handled or how the two parties weigh the different issues or, for that matter, what constitutes a fair deal. If the land is particularly good and similar land is scarce, the “scale” will probably end up tipping a little more to the right favoring the landowner/lessor in making the deal. Conversely if that kind of land is plentiful or of poorer quality, the “fair deal” may end up with the scale tilting a little more to the left of the center position thereby favoring the lessee.

While the lessor would like a lease situation that is totally weighted to the right side of each issue bar (particularly as relates to the “factual” matters), such a “lessor weighted” deal would never be acceptable to a lessee. So if the lessor truly wants to make a deal (and realize a monetary return for the value of his loaned asset), he may have to yield on more of the negotiable points to find that more equitable balance. Conversely a deal that tips too far to the left (particularly as relates to “factual” matters) will need some counterbalancing or concessions by the lessee on negotiable issues before the lessor is apt to find it acceptable and feel a fair deal has been struck.
Attached are two lease negotiation scenarios:

**Scenario I Assumption:**

The prospective lessee is a young farmer recently graduated from college but with no business experience. He seeks to lease five acres on which he proposes to establish a hog farm. There will be some environmental risks (run-off etc.) and odor/noise impacts on nearby properties. The lessor must invest in a road and utilities to the farm site, but at the end of the lease there will be few residual improvements or benefits of value to the landowner, in fact he may be left with a liability (a mess to clean up). The “factual issues” weigh heavily against the lessee and to balance the scale, the lessor can be expected to be quite tough on the more “negotiable” issues, i.e.

- Restrictions on use
- Shorter lease
- Pass-through of certain costs to lessee (i.e. expenses to monitor activities, transactions costs, etc.)
- Some form of participating (or percentage) rent to give the lessor an “upside” reward for the adverse conditions or risks he perceives he’s taking with this lessee/use.
- High base rent per acre
- Shorter known rent periods
- Possibly some unusual restrictions or covenants

**Scenario II Assumptions**

The prospective lessee is a deep pocketed, good credit, multi-national corn seed stock producer with an experienced management team. They need 500 acres, will put in at their expense a water well and substantial warehouse and office facility that will outlive the lease terms, and will pay all front end costs of setting up the lease and operation. In this case, the lessee has an excellent set of “factual issues” which weigh heavily in his favor. This means if the lessor is going to attract the lessee, he’ll need to offer some fairly attractive “negotiable” terms such as:

- Few restrictions on use
- Long lease term
- Lessor may absorb or contribute toward certain costs
- Probably no rent other than a base rent which would be relatively low per acre
- Long known rent periods