

Negotiating Long-Term Ground Leases for Build-to-Suit Buildings

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A. Introduction

1. Characteristics of a Ground Lease

Most commercial leases which real estate lawyers encounter involve the lease of space in a building for a period of years. A ground lease, however, is a much different form of lease whereby the tenant leases the land rather than a building. A ground lease is typically a long-term lease of unimproved land or previously developed property that requires the tenant to construct new improvements¹. Lease terms typically run 50 to 99 years, and generally no less than 30 years². The tenant typically holds ownership of the improvements during the term of the lease and the tenant has the obligation to pay all expenses attributable to the property except the mortgage on the landlord's fee interest and income taxes owed by the landlord³.

2. Reasons for Entering Into a Ground Lease

a. Landlord

For the landlord, there a number of advantages of a ground lease. First and foremost, of course, is the fact that the landlord retains ownership of the fee interest. Additionally, the landlord avoids the risks associated with development of the property.

b. Tenant

The tenant's primary motivation for a ground lease is similar to a primary motivation of the landlord. Whereas the landlord is able to avoid the costs and risks associated with development of the property, the tenant in a ground lease avoids the

¹ Florence P. Mayne, *Ground Leases: Basic Legal Issues*, available at http://www.utsystem.edu/reo/articles/ground%20leases_basic%20legal%20issues.pdf

² *Id.*

³ *Id.*

acquisition costs of the land, thus saving significant cash which would have been required to be paid as a down payment in a standard real estate purchase.

An additional motivation is the fact that the improvements are depreciable, whereas land is a non-depreciable asset. Furthermore, ground rent paid by the tenant is deductible as an ordinary business expense. In other words, there are possible tax benefits for the tenant in a ground lease transaction.

B. Construction and Occupancy: Landlord and Tenant Obligations

The ground lease structure differs significantly from a typically gross or triple-net commercial lease with respect to the obligations of landlord and tenant. In the typical commercial lease transaction, there exists a relative equity of risk-sharing between the parties in terms of obligations such as maintenance and repair of the building. With a ground lease, however, given that the building is owned by the tenant rather than the landlord, it is the tenant who shoulders the bulk of the burden.

1. Landlord Obligations

The landlord's obligations in a ground lease transaction are simple and straightforward: the landlord pays any mortgage against its fee interest and the property taxes relative to the land.

2. Tenant Obligations

By contrast, the tenant is responsible for all aspects of the building which it has constructed upon the land. These matters include insuring the building against fire and casualty loss, keeping the construction of the building free from liens, maintaining and repairing the property, and the like.

C. Provisions Related to the Financing of the Building Construction

The key term in any ground lease is financing, as the tenant typically seeks financing from a third party lender in order to construct the desired improvements upon the land. Whether a ground lease is financeable depends primarily upon whether it is subordinated or unsubordinated.

1. Subordinated Ground Leases

The term “subordinated ground lease” refers to a ground lease in which the landowner has agreed to permit a lien to be placed against the owner’s fee simple interest in the land to secure the payment of the loan made by the construction lender or a subsequent lender to the tenant.⁴ The lender has a lien against both the fee simple interest of the landowner and the leasehold estate of the tenant.⁵ If there is a default under the loan, the lender may foreclose against both the fee title and the leasehold estate, in which case the owner loses the land.⁶

Why would a landlord subordinate its fee interest to the lender’s lien? There are a multitude of reasons therefor. For example, perhaps the financing will permit development of the property in a manner that will enhance neighboring properties owned by the landlord. Or the landlord may seek a share of the profits of the project in exchange for its agreement to subordinate.

Nonetheless, a savvy landlord would be wise to build protections into the ground lease and/or the subordination agreement, as applicable, if the landlord does agree to subordinate. These provisions include the following:

⁴ Mayne, at p. 3.

⁵ *Id.*

⁶ *Id.*

- Requiring a tenant to contribute a specific amount of equity or execute a specific number of subleases as a precondition to the landlord's subordination of its fee interest⁷;
- Capping the maximum amount, interest rate and term of any loan;⁸
- Requiring loan disbursements to be made through a third-party escrow agent and that the owner's consent be given before each disbursement;⁹
- Requiring additional security from the tenant such as a performance bond or personal guaranty;¹⁰
- Requiring notice of the tenant's default under the loan documents and the right and adequate time for the landlord to cure the default;¹¹
- Limiting the subordination to the construction period only or, alternatively, requiring that the loan be repaid early in the term of the ground lease;¹² and
- Allowing only one mortgage and prohibiting renewals, extensions or modifications of the permitted mortgage.¹³

Additionally, and prior to signing the any promissory note and/or subordination agreement, the landlord should make certain that the loan is non-recourse to the landlord; in other words, if the tenant defaults on the loan, the lender's sole recourse vis-à-vis the landlord is to foreclose upon and take ownership of the property and the lender is precluded from pursuing the landlord for any deficiency judgment¹⁴.

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

2. Unsubordinated Ground Leases

In an unsubordinated ground lease, financing is far more difficult given that the lender is entitled only to a lien against the leasehold interest of the tenant/borrower rather than a lien against both the fee and leasehold interests.

If the lender is not willing to subordinate and the tenant intends to obtain financing for its improvements, both parties would be well served by involving lender and its counsel early in the process to reach an agreement. Otherwise, landlord and tenant could conceivably expend countless hours and fees negotiating a ground lease which ultimately is not financeable from the lender's perspective.

3. Key Lease Provisions Relating to Financing

Prudent tenants should negotiate their leases with the following provisions in mind to ensure that they are able to obtain financing with respect to development of the property.

a. Right to mortgage the leasehold.

The lease should permit the tenant to mortgage its leasehold interest without obtaining the landlord's consent¹⁵. This provision should be clearly drafted such that the mortgage and/or transfer of the leasehold estate to the lender does not fall within the language of the assignment/subletting provisions of the lease, which may require the landlord's consent¹⁶. To the extent these provisions are not included in the lease, it is preferable that the lease be modified¹⁷. Otherwise, it may be necessary to obtain specific

¹⁵ Gregory S. Baker, *Elements of a Financeable Ground Lease*, BANK ON IT! Spring 2002 available at <http://www.szd.com/resources.php?PublicationID=445&method=unique>

¹⁶ *Id.*

¹⁷ *Id.*

landlord consent to the mortgage transaction, as well as to the lender's exercise of its remedies upon default¹⁸.

b. Free assignability of the leasehold.

Preferably, a lease will give tenants the right to freely assign their leasehold estate¹⁹. As discussed above, unless the lease provides that the landlord's consent is not required for an assignment of the lease to the tenant's lender, a specific consent to the lending transaction must be obtained²⁰. But the benefit of free assignability goes further. The tenant should have broad rights to assign its leasehold estates to third parties²¹. If the Tenant does not have such rights and the tenant's lender recovers possession of the premises, then the lender may be required to obtain the landlord's consent before it can further assign the lease²². This can make it difficult for the lender to put a replacement tenant in place²³. Thus, the lease should include a provision that the tenant's lender, upon succeeding to the tenant's interest under the lease, will not be subject to any lease provisions which impair the transferability of the lease²⁴. Similarly, if the lease is terminated for any reason, the landlord should be required to enter into a new lease with the tenant's lender²⁵. The terms of such new lease should permit the lender (or successor-tenant) to assign its leasehold interest without restriction²⁶. The new lease should also

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² *Id.*

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

provide that the landlord waives any right to collect any proceeds from any assignment made by the lender²⁷.

c. Protection from foreclosure.

Clearly, lenders want their leasehold mortgages to have priority over other mortgages²⁸. The best way to accomplish this is to record the leasehold mortgage prior to any mortgage granted by the owner-landlord on the underlying ownership interest in the land²⁹. A ground lease should include a provision prohibiting the owner-landlord from mortgaging the underlying ownership interest in the land³⁰. If the owner/landlord insists upon the right to place a senior mortgage against the ownership interest in the land, then the lease should provide that upon any such financing, the leasehold mortgagee must execute a commercially reasonable subordination agreement, which would include an agreement by the mortgagee of the ownership interest to not disturb the ground lessee's (or leasehold mortgagee's) possession of the premises in the event of a foreclosure³¹.

If there is an existing mortgage on the ownership interest in the land, a lender's subsequent leasehold mortgage may be extinguished if the mortgage on the ownership interest in the land is foreclosed³². To avoid this, the ground lease should include a provision which obligates the landlord to obtain from the landlord's lender, a commercially reasonable non-disturbance agreement, whereby the landlord's lender agrees not to disturb the possession of the ground lessee (or the ground lessee's bank) in the event of foreclosure³³. Although the provision will give the lender assurance that its

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.*

³² *Id.*

³³ *Id.*

leasehold mortgage will not be extinguished by foreclosure of the mortgage on the ownership interest, it is important to note that the non-disturbance agreement might be considered an executory contract and, as a result, could be disaffirmed in a bankruptcy proceeding of the landlord's lender³⁴.

d. Limitation of the lender's liability under the lease.

Lenders should not be accountable for the defaults of tenants³⁵. Thus, the lease should clearly limit the lender's liability to the period of time it actually owns the leasehold estate and provide that the lender's liability ceases after it has assigned or transferred the lease to a third party³⁶. As a compromise, sometimes a lender will agree to take over a lease subject to, and to cure any, non-monetary defaults under the lease which exist at the time the lender takes possession of the premises³⁷. Sometimes, landlords will insist that the lender cure all monetary defaults of the tenant prior to taking possession of the premises³⁸. Obviously, a landlord which includes this type of requirement does not want to be put into the position of collecting on monetary defaults directly from the tenant under the lease, even though it has the legal right to do so³⁹. Lenders should prefer that there be no such obligation⁴⁰. Ultimately, whether a lender agrees to finance a lease containing such a provision will depend on the credit-worthiness of the borrower-tenant⁴¹.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

e. Future improvements.

A lender should not be required to make improvements to the premises if it succeeds to the tenant's interest under the lease⁴². If the tenant is obligated to make future improvements to the premises, then the lease should specifically provide that the lender is absolved of the responsibility of making such improvements if it acquires the interest of the tenant under the lease⁴³.

f. Anti-merger clause.

If the tenant has an option to acquire the underlying ownership interest, then the lease should specifically prohibit the merger (or combination) of the leasehold and ownership interests⁴⁴. In other words, since the tenant will have mortgaged the leasehold interest alone, the lender will want to be sure that the lease will not be extinguished upon any acquisition by the tenant of the ownership of the land⁴⁵. Rather, the two interests - the ownership and the leasehold - should remain separate and distinct⁴⁶.

g. Use clause.

It is important that the lease include a broad use clause so that if the lender acquires the tenant's leasehold estate, it has a broader market for the sale of that interest⁴⁷. Tenants should insist that if the lender succeeds to the leasehold estate that the lender has the right to lease the premises for any lawful use⁴⁸. In addition, it is preferable for a lender if, in the case of a shopping center or other retail lease, the terms of any then existing exclusive use provision which benefits the tenant should also benefit a lender

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

that takes over the tenant's leasehold, and, any such exclusive use provision benefiting another tenant of the shopping center and restricting use by the tenant under the mortgaged leasehold should not apply to a lender taking over the leasehold⁴⁹. At the least, the lender must carefully examine the use restrictions in the lease to ensure that its ability to effectuate a change in use of the premises is not so constrictive that the landlord would be effectively precluded from realizing any value upon the sale of its security⁵⁰.

h. Lease modifications.

The lease should provide that its terms may not be changed without the lender's consent⁵¹. Landlords may object to such a blanket restriction⁵². Lenders should be prepared to negotiate on their consent rights as to those matters which do not increase a tenant's obligations under the lease, affect the lender's security in the lease or impair the value of the lease as collateral for the leasehold mortgage loan⁵³.

i. Casualty and/or condemnation.

Lenders secured by real estate, for obvious reasons, require that they be the named insured against casualty loss under a standard mortgagee clause⁵⁴. In the event of a casualty, this will result in the proceeds being payable to the lender⁵⁵. The same is true of condemnation: a lender will generally require that any proceeds be paid directly to it⁵⁶. In addition, lenders secured by real estate typically enjoy a contractual option to apply any insurance or condemnation proceeds against the mortgage loan indebtedness rather

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.*

than to the restoration of the premises⁵⁷. Not surprisingly, landlords also generally want access to insurance/condemnation proceeds in order to reconstruct the premises upon any casualty or taking⁵⁸. Lenders will often compromise on this issue by allowing reconstruction so long as the borrower is not in default, the proceeds are sufficient to reconstruct the property, the property is still economically viable, a standard mortgagee clause is included in the lease, and the lender has an option to become involved with the disbursement of the proceeds and adjustment of losses⁵⁹.

j. Default notices and opportunity to cure.

Lenders financing a ground lease should receive copies of notices of default which could result in the termination under the lease⁶⁰. The lease should afford the lender a greater period of time to cure the tenant's default under the lease, thereby precluding a situation in which a landlord is forced to cure a tenant's breach before the tenant's opportunity to do so has expired⁶¹. Also, if the default is in the nature that possession of the premises is required in order to cure, then the landlord should not have the right to terminate the lease until after the expiration of a reasonable time for the lender to obtain possession of the premises and cure the default⁶². A lender should also attempt to exonerate itself from those events of default which it is incapable of curing⁶³. For instance, upon termination of the lease prior to its expiration, the lender should have the right after foreclosure to obtain a new lease for the remainder of the term upon the same

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*

terms and conditions as the tenant's lease⁶⁴. Lenders are wise to demand a reasonable time to effectuate cures under the lease as opposed to requiring a new ground lease because an agreement to enter into a new lease is an executory contact that can be set aside in the event of the landlord's bankruptcy.⁶⁵

k. Rent increases.

If the lease contains provisions which increase the base rent prior to the maturity of the leasehold mortgage loan, the tenant should review the rent terms with its lender to ensure that the lender (or any successor or transferee) can live with such terms in the event it succeeds to the tenant's interest under the lease.⁶⁶

l. Lease Term.

Generally, ground leases that are proposed as security for a loan are long-term.⁶⁷ It probably goes without saying that a lender will want the ground lease upon which it takes a mortgage to extend well beyond the maturity of the loan.⁶⁸ If the lease expires at or shortly after the maturity of the loan, the lender might be left with worthless collateral at such time as the loan is to be fully paid and the borrower unable to pay or refinance.⁶⁹ It is also obvious that the longer the term of the lease, the greater its value.⁷⁰ This is not a point that is likely to be lost with most lenders, and would arise in connection with an appraisal of the property.⁷¹

However, lenders should ensure that the tenant exercises all renewal options available under the lease, especially if the renewal term(s) are included in determining the

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.*

appraised value of the property.⁷² Because renewal options in the lease are considered executory contracts, they can be set aside in the event of the landlord's bankruptcy.⁷³ Once exercised, the renewal options are not considered executory contracts.⁷⁴ Thus, a lender should insist that the tenant under the lease exercise its renewal options prior to the closing of the loan.⁷⁵

D. Unique Issues with Mixed-Use Leasing

Many ground leases involve the landlord leasing a parcel of improved land to a single tenant who in turns develops the property for its own use. However, in some instances, the tenant seeks to develop the property as a mixed-use development with the intent to sublease portions of its building to a mixture of retail businesses. In these instances, another third party – i.e., the subtenant – and its needs comes into play. A subtenant of a ground lessee needs to be certain that no provision of the ground lease adversely impacts the subtenant's proposed use, operations or exit strategy.

In a typical sublease, the sublessor provides the sublessee with a copy of the master lease. Given some of the unique terms of a ground lease, however, some sublessors may instead opt to provide a redacted copy or selected sections which it deems pertinent to the sublease relationship. If the latter is the case, the subtenant should require a certification from the landowner as to the accuracy of the information provided by the tenant/sublessor.

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.*

E. Conclusion

In the right circumstances, a ground lease can provide a means to develop or re-develop a parcel of land. Practitioners should be aware of the key elements of ground leases should the opportunity or need arise to structure such a deal.