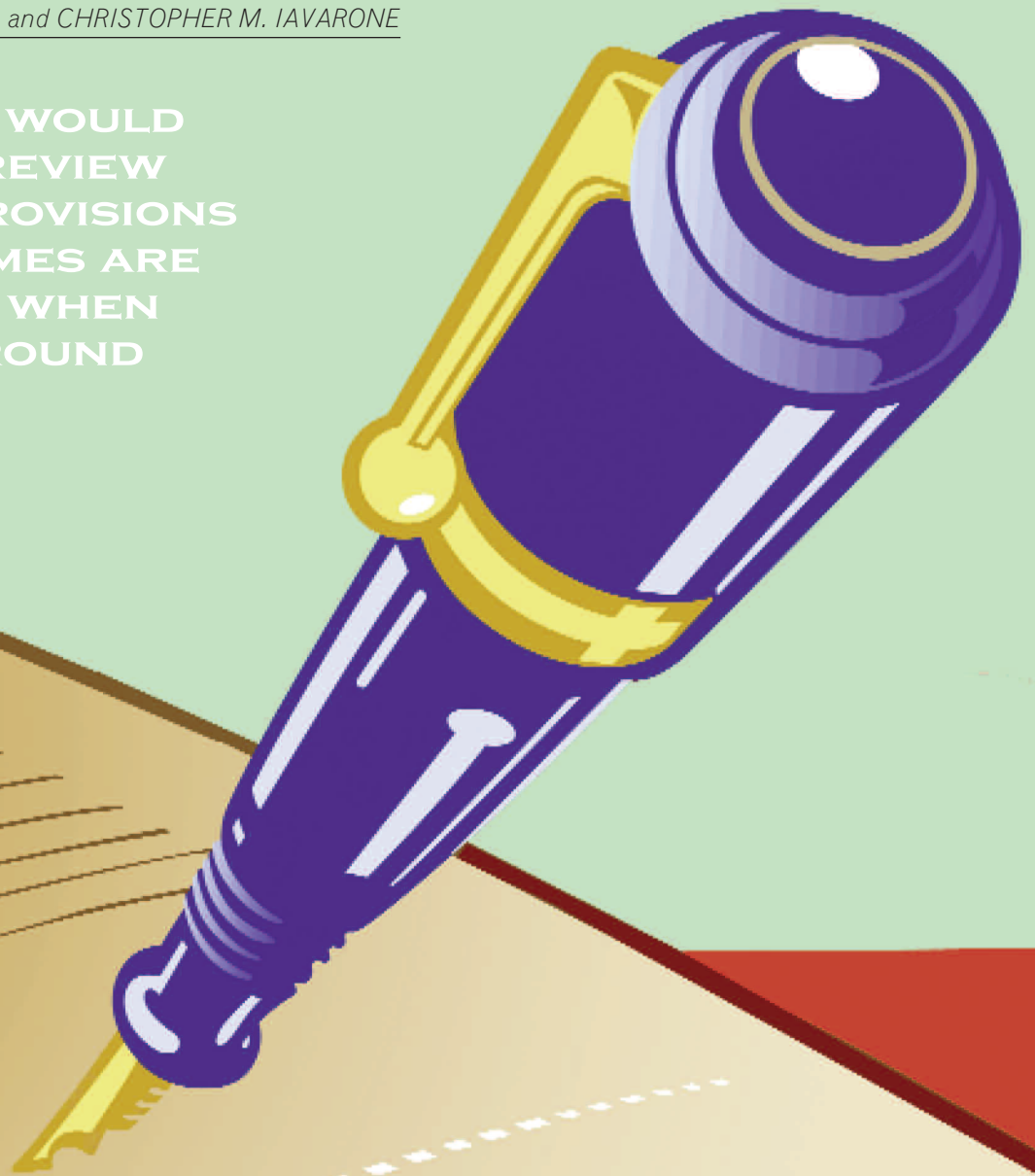


FINANCING A GROUND LEASE

18 ESSENTIAL TERMS

BY PAMELA V. ROTHENBERG and CHRISTOPHER M. IAVARONE

DEVELOPERS WOULD DO WELL TO REVIEW THESE KEY PROVISIONS THAT SOMETIMES ARE OVERLOOKED WHEN WRITING A GROUND LEASE.



Ground leases present complicated issues that differ from those typically negotiated in real estate purchase transactions. From a real estate developer's perspective, a well-written ground lease must give the developer rights that enable it to function during the lease term as if it were the outright owner of the land.

One critical element is that the ground lease be financeable by the developer's lender. To achieve this result, the ground lease must contain a number of provisions that are frequently overlooked as the developer and the landowner appropriately focus on other business terms of their transaction.

GROUND LEASE BASICS

A ground lease is a long-term lease of land between a fee-owning landlord and a tenant. During the term of the lease, in exchange for its rental payments to the landlord, the tenant obtains the right to construct and operate improvements on the land. Ownership of those improvements remains with the tenant throughout the lease term, but the improvements become the landlord's property when the lease terminates or expires (this is called a reversionary interest). The landlord retains its fee simple title (absolute, unconditional ownership with freedom of disposition) to the land during the term of the ground lease. If the tenant defaults under the lease, the landlord can terminate the lease and become the owner of the improvements, typically free and clear of the liens securing the tenant's financing.

GROUND LEASE FINANCING CONCEPTS

A ground lease must be capable of being financed without encumbering the landlord's fee simple estate in the land and reversionary interest in the improvements. Under these circumstances, if the tenant defaults under the ground lease, the tenant's lender (the "leasehold mortgagee") risks a complete loss of its collateral, since upon the landlord's resulting ter-

mination of the lease, the tenant's leasehold estate and the leasehold mortgagee's lien are "wiped out" and the improvements revert to the landlord on a free and clear basis. It is common for a landlord to refuse to encumber its fee simple interest in the land or its reversionary interests in the improvements to secure the tenant's financing. Consequently, a ground lease must include certain cure rights and other key terms in favor of the leasehold mortgagee to protect it from such a catastrophic loss.

ESSENTIAL TERMS OF A FINANCEABLE GROUND LEASE

For a ground lease to be acceptable to a leasehold mortgagee without encumbering landlord's fee simple estate in the land and reversionary interest in the improvements, it should generally include the following key terms. Not every ground lease must address these issues in the exact manner described below because there are multiple ways to provide a benefit or protection to the tenant or its leasehold mortgagee. However, some combination of these terms should be included in the ground lease to effectively protect the leasehold mortgagee.

1. TERM. The term of the ground lease must exceed the loan term. Leasehold mortgagees typically face regulatory requirements for a minimum "cushion" when it comes to the length of the lease term. For example, the loan term on fully amortizing basis should not exceed 75 percent of remaining lease term. The leasehold mortgagee probably cannot rely on unexercised renewal options to satisfy this regulatory requirement.

2. RENT. During the term of the ground lease, rent increases must be reasonably predictable. Unless rent escalations are determinable, the leasehold mortgagee may not be able to evaluate the "fair market value" of the leasehold estate to determine whether the leasehold mortgagee has satisfied its legal investment requirements. If the ground lease provides that any rent escalations are to

NEITHER THE TENANT NOR THE LANDLORD SHOULD HAVE ANY RECONSTRUCTION RIGHTS OR OBLIGATIONS WITHOUT THE LEASEHOLD MORTGAGEE'S APPROVAL AND CONTROL.

be determined based on an appraisal of the land, the leasehold mortgagee may impose a limitation on the potential rent increases to then-present use of the land and improvements (and not the highest or best use). In this case, the ground lease should also include rights in favor of the leasehold mortgagee to help select the appraiser, set the appraisal requirements (e.g., minimum value) and challenge the appraisal results.

3. USE, EASEMENTS AND ALTERATIONS. To ensure its long-term viability, the ground lease should include a broad, permitted use clause entitling the tenant to freely change the property's use over the term of the lease. The lease should also require the landlord to join in all easements, covenants, conditions and restrictions, permit applications and dedications reasonably necessary for the property's development. The lease should permit the tenant, at its cost, to alter and replace the improvements to meet changing market conditions so long as the value of the property is not diminished.

4. RIGHT TO SUBLEASE. The tenant must have the right to sublease all or part of the premises without the landlord's consent so long as the subleases are subordinate and subject to the ground lease and do not extend beyond the term of the ground lease.

5. CONDEMNATION. If the property is condemned, the ground lease should provide for an equitable sharing of the condemnation award. First, the landlord should receive the value of the land as unimproved and not subject to the burden or benefit of the ground lease. Second, all of the tenant's leasehold mortgagees should be paid off. Third, the

tenant and the landlord should split the value of the leasehold improvements based on useful life and remaining lease term. The ground lease must permit the leasehold mortgagee to participate in the condemnation proceedings. If the property suffers a partial or temporary condemnation, the landlord should first receive the value of the land taken and then the leasehold mortgagee should receive that portion of the award necessary to bring the loan-to-value ratio and net income to debt service ratio for the loan back to the same percentages as when the tenant's loan was underwritten.

6. INSURANCE AND CASUALTY. In the event of a casualty affecting the leasehold improvements, the tenant, rather than landlord, should receive the insurance proceeds. The leasehold mortgagee, in turn, will likely make the proceeds payable to itself. The tenant and the leasehold mortgagee must rebuild the leasehold improvements if feasible; however, this obligation to rebuild should be limited to the extent of available insurance proceeds. Also, the ground lease should eliminate the tenant's obligation to rebuild during the last "x" years of the term of the lease (e.g., last two years of a 20-year lease, or last five years of a 50-year lease). Neither the tenant nor the landlord should have any reconstruction rights or obligations without the leasehold mortgagee's approval and control. All hazard insurance policies maintained by the tenant should contain a standard mortgagee clause where the policy is non-cancelable without at least 30 days' notice to the landlord and to the leasehold mortgagee. If the ground lease is terminated as a result of the casualty, the leasehold mortgagee should be

ambling management company

TO ENSURE ITS LONG-TERM VIABILITY, THE GROUND LEASE SHOULD INCLUDE A BROAD, PERMITTED USE CLAUSE, ENTITLING THE TENANT TO FREELY CHANGE THE PROPERTY'S USE OVER THE TERM OF THE LEASE.

repaid first from the insurance proceeds before any payment is made to the landlord or tenant.

7. NON-RECOURSE LEASE. The ground lease should be non-recourse against the tenant except to the extent of the tenant's interest in the leasehold estate and the improvements, and except for customary environmental obligations and personal liability for wrongful acts. This non-recourse provision provides assurances to the leasehold mortgagee that it will not be subject to personal liability if it exercises its loan remedies and steps into the tenant's shoes under the ground lease.

8. TENANT'S RIGHT TO MORTGAGE. The ground lease should include rights in favor of the tenant to assign and mortgage the lease and the tenant's leasehold estate as security for the tenant's financing. This should include the tenant's right to collateralize the tenant's interest in any subleases for the improvements (including sub-rents and security deposits) and the tenant's interests in any condemnation awards and insurance

proceeds. The tenant must be permitted to freely assign to the leasehold mortgagee all of its rights under the ground lease.

9. REQUIRED PROVISIONS FOR THE LEASEHOLD MORTGAGEE. The ground lease must afford the leasehold mortgagee the rights and remedies customarily afforded to real-estate secured lenders for any borrower loan default. These include rights for the leasehold mortgagee, without the landlord's consent, to foreclose and sell or resell the tenant's leasehold estate and interests in the improvements, to appoint a receiver, to enter upon and/or operate the leasehold premises, to sublease the premises, to cure the tenant's default under the ground lease and to require the landlord to accept such cure on behalf of tenant. The leasehold mortgagee should also have affirmative rights under the ground lease to inspect the tenant's premises.

10. ASSIGNMENT RIGHTS. After becoming the tenant (by foreclosure or voluntary conveyance), the leasehold

mortgagee must have the right to freely assign or sublet the leasehold estate without the landlord's consent. Further, the landlord should not have the right to impose any conditions on the assignment or subletting so long as the new tenant (i.e., the assignee) agrees to assume the obligations under the lease arising after the assignment and to cure the existing tenant's monetary and non-monetary defaults that relate to the premises (e.g., delinquent real estate taxes, insurance premiums, deferred maintenance, etc.). In addition, following any assignment, the leasehold mortgagee should be released from all future obligations under the ground lease once the new tenant assumes the ground lease (but not obligations that arose during the leasehold mortgagee's period of ownership or were assumed by it when it acquired the property and should have been performed during its ownership).

11. LANDLORD'S AGREEMENTS. The landlord must agree not to accept voluntary prepayments of rent or any surrender or termination of the ground lease by the

Texacraft

THE LEASEHOLD MORTGAGEE SHOULD BE AFFORDED AN ADDITIONAL GRACE PERIOD TO CURE THE TENANT'S DEFAULT UNDER THE GROUND LEASE.

job loss prot

tenant. Further, the landlord should be prohibited from amending, supplementing or canceling the ground lease without the leasehold mortgagee's consent. The landlord should also covenant to cause any mortgage encumbering the landlord's fee simple interest in the land to be subordinate to the lien, operation and effect of the ground lease. The landlord's lender should subordinate its fee mortgage to both the right of the leasehold mortgagee to obtain a new ground lease after the termination of the original lease and to the lien, operation and effect of any such new lease.

12. NOTICE OF TENANT'S

DEFAULT. The landlord should be required to give notice to the leasehold mortgagee of the tenant's default under the ground lease. The leasehold mortgagee should be afforded an additional grace period to cure the tenant's default under the ground lease. If, in order to exercise such cure rights, the leasehold mortgagee must foreclose on its leasehold mortgage or enforce its rights in a tenant bankruptcy proceeding, or appoint a receiver to obtain possession of the tenant's premises under the ground lease, the leasehold mortgagee should be afforded an unlimited grace period as long as the rent and other monetary obligations due under the ground lease are paid on a current basis.

13. CURE BY LEASEHOLD

MORTGAGEE. The landlord must be obligated to accept the leasehold mortgagee's performance as the tenant's performance in curing a default. The ground lease should provide that it cannot be terminated because of a default by the tenant that is not curable by the leasehold mortgagee (e.g., a bankruptcy filing by tenant) as long as the leasehold mortgagee continues to pay all rent and diligently proceeds to cure all defaults that are curable by it. Moreover, any such incurable default

should be waived by the landlord when the leasehold mortgagee becomes the tenant following foreclosure or assignment of the leasehold estate in lieu of foreclosure.

14. NEW LEASE. If the ground lease is terminated by the landlord because of tenant's continuing default, the landlord should be obligated to provide notice of termination to the leasehold mortgagee. If within a specified period (i.e., 30 days) after this notice, the leasehold mortgagee pays all back rent and additional rent then due plus the landlord's expenses and attorney's fees in terminating the lease, the landlord should be required to enter into a new direct lease with the leasehold mortgagee. This new lease should be on the same terms and conditions as the original lease and have the same priority with respect to the landlord's existing fee mortgages or any new fee mortgages for the balance of the lease term. The lender's liability, as the tenant under the new lease, should be limited to the period of its occupancy.

15. RECOGNITION AND ATTORNMENT. If the landlord has given recognition and non-disturbance agreements in favor of the tenant's subtenants and the subtenants have agreed to attorn to the landlord (i.e., agree to become the direct tenant of the landlord under the terms of their subleases following a termination of the ground lease), then any existing occupancy subleases will become senior leases if the ground lease is terminated prior to the end of its term. In that case, the tenant's occupancy subleases should provide that if the leasehold mortgagee enters into a direct lease with the landlord after the termination of the ground lease, the subleases automatically revert back to their prior subordinate position. The landlord should only have the right to evict such subtenants for uncured defaults under their subleases. However, if

THE LANDLORD SHOULD ONLY HAVE THE RIGHT TO EVICT SUCH SUBTENANTS FOR UNCURED DEFAULTS UNDER THEIR SUBLEASES. HOWEVER, IF THERE IS NO RECOGNITION, NON-DISTURBANCE AND ATTORNMENT BETWEEN THE LANDLORD AND THE SUBTENANTS, THEN THE SUBLEASES WILL BE EXTINGUISHED AUTOMATICALLY IF THE GROUND LEASE IS TERMINATED.

there is no recognition, non-disturbance and attornment between the landlord and the subtenants, then the subleases will be extinguished automatically if the ground lease is terminated. Often a landlord will agree to recognize and not disturb a subtenant only under certain conditions, such as for a major sublease.

16. NON-MERGER. The ground lease should be clear that no merger of the tenant's leasehold estate and the landlord's fee simple estate will occur without the written consent of all parties with interests in the ground lease, including the leasehold mortgagee.

17. MEMORANDUM OF LEASE. A memorandum of the ground lease must be recorded among the land records prior to any lien

encumbering the landlord's fee interest in the land and improvements.

18. ESTOPPEL CERTIFICATES. The lender must have the right at any time to require that the landlord and the tenant certify key facts typically included in estoppel certificates, including the validity and effect of the ground lease as amended, whether there exist any defaults under or offset rights, counterclaims or defenses relating to the ground lease and the amounts and status of rental payments.

A ground lease can be an effective means for a developer to obtain control of land that a fee owner might not otherwise sell. It also affords a developer the benefit of gaining control over a site without having to carry the land costs on its books before its project has been completed and

is generating cash flow. However, to be successful, the ground lease must be financeable and include essential terms that protect the leasehold mortgagee from a catastrophic loss of its collateral. ■■

Pamela V. Rothenberg, reachable at prothenberg@wcsr.com, is a real estate attorney in the Washington, D.C., office of Womble Carlyle Sandridge & Rice. She leads the firm's multifamily real estate industry team and is a member of the firm's real estate practice group. Christopher M. Iavarone, reachable at christopher.iavarone@clydeco.com, is a real estate attorney in the London, UK-office of Clyde & Co. and also works as an outside contract attorney for the real estate practice group at Womble Carlyle Sandridge & Rice.

cam online