



Ground Lease Fundamentals - What Distinguishes a Ground Lease and Why

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Ground Lease Fundamentals

Ground leases, whereby a commercial developer leases a parcel of land and constructs its improvements on the leased property, have long been used as a vehicle for the development of commercial real estate. Long-term ground leases of publicly owned property have also become a primary tool of governmental and quasi-governmental entities to generate operating income while preserving ownership of valuable assets.

Developers and property owners choose this structure for a variety of reasons. From the perspective of a developer, a ground lease enables the developer to obtain the right to occupy and use the land with little up-front investment of cash. From the property owner's perspective, it generates an income stream from the land without investing the time and capital needed to construct improvements, and preserves ownership of the land for future use.

The current availability of capital for any type of real estate transaction is limited. With the credit crunch, lenders of commercial mortgage-backed securities (CMBS) had pulled back generally in the market.

However, as the real estate economy is normalizing, leasehold mortgage financing may once again become a viable financing technique for real estate developers. With that in mind, real estate developers and owners considering the pros and cons of ground leasing must realize that the successful development of commercial property under a ground lease structure depends in large part on whether the ground lease meets the lender's expectations vis-à-vis the underwriting of ground lease risk.

The market trend of nonrecourse financing makes this exercise more difficult. Rather than shift such risks to a borrower, lenders must rely solely on a lien against the ground lessee's interest in the leasehold estate. As such, the success of a ground lease project may be dependent on the ability of the developer to secure lender-friendly concessions from the fee owner.

Big box or other major franchise convenience food or retail business are typically experienced and sophisticated with respect to ground leasing. Often they will approach a negotiation based on their own self-generated form, which is well integrated with ground lessee and lender protections. Their ground leases generally contain certain commonly used features. Purchasers of property subject to existing ground leases, in particular convenience food or shopping center leases with national or regional franchise occupants, should expect that the ground lease probably contains these features and should review title carefully to determine if they exist.

I. INTRODUCTION – WHAT DISTINGUISHES A GROUND LEASE AND WHY

What distinguishes a “ground lease” from an ordinary real estate lease? Like an ordinary lease, under a ground lease a tenant or lessee pays rent to a landlord or lessor and receives in return a right to possession and use of the property for the time period covered by the rent. Like an ordinary lease, ground leases generally call for rent to be paid on a periodic basis, typically monthly. Finally, like an ordinary lease, the landlord generally has the ability to evict the ground lessee as one of the remedies for non-payment.

However, just as the leasing industry divides commercial leases into categories such as “net”, “gross”, “full service”, etc., there are some generally understood parameters involved in a ground lease.

First, a ground lease generally involves either raw unimproved land or land with improvements that the landlord does not intend to preserve in their present condition – either a complete “tear-down” or such a significant renovation that the extant improvement will essentially be made into something new.

Second, a ground lease is generally structured around the notion that the tenant will develop or construct a significant improvement on the land for its own use. During the ground lease term, the tenant will typically own and depreciate the improvements. At the end of the term, ownership of the improvements may revert to the fee owner or the ground lessee may be required to remove them.

Third, and probably most significantly, ground leases ordinarily have a fairly long term. Historically many ground leases had terms of 99 years.

Stepping back from the individual details, the over-arching aspect that sets a ground lease apart is a structure that puts the ground lessee in a position similar to that of a property owner in many respects.

A. Term

Because the lessee under a ground lease will generally construct improvements on the land being leased, the lease term must by necessity be at least long enough to allow the ground lessee to amortize the cost of those improvements over a meaningful time period, “meaningful” being long enough to generate sufficient income from the improvements to pay for them and realize a commercially reasonable return based on prudent income and cost projections.

How is this determined? Historically, many ground leases had a term of 99 years. There are several differing explanations for why this is the case. It generally appears that this was a tradition inherited from British common law that came to be embedded into the law of many states.

There were a number of problematic issues that arose with these longer term ground leases, a few of which will be discussed below.

Modern ground leases generally do not involve terms of 99 years. Rather, the term of a modern ground lease is determined in accordance with the cost of the facility developed on the property and its intended use. There are two drivers of this process. First, as noted above, the ground lessee must be able to amortize the cost of the improvement and earn a reasonable return. Second, if the ground lessee has obtained financing, the lender will want the term to be long enough to amortize the financing completely, with some additional time in the event the lender needs to foreclose and sell the ground lease.

The term is driven in most cases by the financing obtained by the ground lessee. Generally, a lender taking a ground lease as security will require the term of the ground lease to extend 5 or perhaps 10 years beyond the maturity of the financing.

Big box ground leases often have an initial term of 40 years, plus options allowing the ground lessee to extend well beyond that. Given the magnitude of the initial investment, 40 years is probably the minimum time necessary to pay for the improvement and realize a reasonable profit.

Fast food ground leases, such as McDonald's, El Pollo Loco, etc., may have an initial term closer to 20 years.

The following is a typical term provision from a ground lease:

Lease Term. The term of this Lease (the "**Lease Term**", the "**Term**" and/or the "**Initial Term**") shall commence on the Effective Date, as defined in **Section _____**, and shall continue for a period ending on the last day of the month which is forty (40) years following the Rent Commencement Date, as defined in **Section _____**, below. The terms "**Term**" and "**Lease Term**" shall also include any Extension Term, as defined in **Section 2.5**, below, if the context reasonably requires.

B. Rights and Responsibilities of Lessor and Lessee

Ground leases will contain the usual sets of responsibilities common to any lease, such as payment of rent by lessee and tender of possession by lessor. However, there are some features that tend to be unique to ground leases.

The improvements on the real property will belong to and be under the control of the ground lessee during the term of the ground lease, but they will either belong to the ground lessor or will be required to be removed by the terms of the ground lease upon the expiration of the ground lease.

Generally, the ground lessee is solely responsible for all due diligence on the property, including applying for and obtaining permits and other approvals from applicable governmental authorities to develop its improvements. Since the ground lessor owns the fee, most ground leases require the ground lessor to cooperate with the ground lessee in this process. Here is a typical cooperation clause:

In order to aid Tenant in meeting governmental requirements for construction and operation of the retail improvements contemplated by Tenant, Landlord shall execute and submit such applications, variances or requests as may be necessary for or required by the owner of the Demised Premises and shall provide any information privy to, known by, or in the possession of Landlord which may be necessary or useful in completing applications, submittals or requests to governmental

authorities having jurisdiction over the Demised Premises. Landlord will cooperate with Tenant in obtaining clarification information and documentation on behalf of Tenant.

C. Financeability

The fact that the ground lessee will be financing the improvements necessitates a suite of features peculiar to ground leases. A lender providing financing to a property owner takes the property itself as collateral. In the case of a foreclosure, the lender can sell the property.

In contrast, in a ground lease, the only rights the lender can take as collateral are the ground lessee's leasehold estate in the land, plus the ground lessee's ownership of the improvements on the land.

Though in an ordinary lease, termination upon default is considered normal, where there is a lender, the potential termination of the lender's collateral creates unacceptable risk and makes the deal un-financeable. Thus, no matter what, to be financeable a ground lease must contain protective provisions designed to place the lender in a position to prevent or cure the defaults and otherwise preserve the value of the leasehold for sale to a third party. The basic idea is that it must be essentially impossible to lose the lease due to inadvertence or mistake, and in every instance of default the lender must have notice and an opportunity to cure.

If the lease were to be terminated – for example, in the case of a bankruptcy rejection by the ground lessor – the mortgagee will want the right to have an automatic new lease with the successor owner, though that is problematic from a priority standpoint. In general this should not be a concern because Section 365(h) allows the lessee of a debtor to choose between the termination of the lease and the continuation of the leasehold if the debtor rejects its unexpired lease of real property. This right should be assigned by ground lessee to ground lease lender in the loan documents. However, see the discussion of the *Qualitech* case, below, for more on this topic.

If ground lessee files bankruptcy and rejects the lease, the assignment to lender can be jeopardized. In this case, aside from language in ground lease stipulating to relief from stay, often the best that can be done is a stipulation with ground lessor that lease remain in effect or is effectively re-signed by lessor (but creating possible priority issues).

One resource for information about this is Fannie Mae form 4326 (ground lease requirements). www.fanniemae.com

Though this is an underwriting issue more than a business issue, there should be no restrictions on the ground lessee's ability to refinance its ground lease issue based on the value of the underlying fee.

Other such provisions include:

1. Title Insurance for Ground Lease Lender

Currently there is no ALTA form specific to leasehold, but the current ALTA owner's policy can be used, with endorsement (13-06 = owner's lease endorsement) (13.01-06 = lender's lease endorsement).

www.alta.org (products/policies/endorsements).

2. Use Provision

A financeable ground lease will need to contain a use provision that is sufficiently broad such that the lender can realize value from a sale of the leasehold even if the business of the original ground lessee proves to be non-viable. In the event of a default, the lender will want to sell the ground leasehold to yield money to pay down the outstanding balance. A narrow use clause will limit the pool of potential buyers.

Lenders prefer an extremely broad use provision, such as one granting authority to use the property for "any lawful purpose". At a minimum, the use provision should be broad enough to allow for most (if not all) uses that could be reasonably anticipated given the size, location and nature of the land. If the lessor has a consent right, it should be highly restricted and narrowly applicable (in other words, the lessor should only be able to withhold consent for a narrow category of items).

A ground lessor concerned about certain uses should include a list of prohibited uses in the memorandum of lease. The following is an example of the type of list often seen in connection with retail ground leasing:

An adult type bookstore or other establishment selling, renting, displaying or exhibiting pornographic or obscene materials (including without limitation: sexually explicit magazines, books, movies, videos, photographs or so called (sexual) toys) or providing adult type entertainment or activities (including, without limitation, any displays or activities of a variety involving, exhibiting or depicting sexual themes, nudity or lewd acts);

A check cashing or "payroll loan" facility or massage parlor;

A mobile home or trailer court, labor camp, junkyard or stockyard;

A scrap facility, land fill, garbage dump, garbage transfer station, or other such facility for the dumping disposing, incineration or reduction of garbage;

Assembling, manufacturing, industrial, distilling, refining, plating or smelting facility; or

An establishment selling illicit drug paraphernalia.

3. Casualty and Condemnation Provisions

a. Casualty

As with financing secured by fee title, the lender will maintain direct control over the borrower's insurance proceeds. This can be at odds with the landlord's boilerplate, which often incorporates some level of landlord involvement in tenant's insurance or, at the very least, naming the landlord as an additional insured on tenant's CGL policy. It should be expected that the lender will require the ground lease to expressly grant the lender the right to participate in the adjustment of losses and settlement due to a casualty. It is more likely in ground lease scenarios that the lender will want the insurance proceeds to be applied to the loan rather than restoration, particularly if loss occurs near the end of the ground lease term.

The lender may also require that the ground lease provide that neither the ground lessor nor the ground lessee will have the right to terminate the ground lease in the event of a casualty except with the consent of the lender.

b. Condemnation

The lender will also likely require a right to participate in condemnation proceedings. As with casualty proceeds, the ground lease should provide that (a) the lender receives the condemnation award to the extent of the outstanding balance of the loan, and (b) the ground lease may be terminated only after the lender has received sufficient proceeds to repay the loan. If the condemnation award is not enough to repay the loan, the lease should continue until the loan has been repaid in full.

4. Fee Mortgages

Financeable ground leases often prohibit the ground lessor from granting any mortgage against the fee or subordinating the ground lease to any fee secured financing.

Ground lessees and lenders should consider taking certain steps to assure that no fee mortgages exist prior to its ground lease, including obtaining a policy of title insurance and recording a memorandum of the ground lease. If there is an existing fee mortgage, the mortgagee will often agree to enter into a subordination, nondisturbance and attornment agreement ("SNDA") under which the leasehold mortgagee agrees not to disturb the ground lessee if the fee mortgage is foreclosed.

The ground lease lender should have the first priority interest in income from subtenants of the ground lessee. Naturally the lender will require standard assignments and SNDA's from these subtenants.

5. Right to Mortgage the Leasehold Estate

To be financeable, the ground lease should include the right of the ground lessee to mortgage the leasehold without obtaining the ground lessor's consent, coupled with the right of the lender to enforce its rights under the leasehold mortgage against the ground lease as its collateral, including the acquisition of the ground lessee's leasehold interest in the property by foreclosure, deed in lieu of foreclosure or otherwise.

This should be coupled with sale of the estate to a third party, again without lessor consent.

The ground lessor might consider imposing some limits on the type of entity that can hold the ground lease mortgage. It should not be a path for tenant subterfuge, bringing in an affiliate or less than arm's length "lender" for the purpose of circumventing an otherwise ordinary lease default. Consider limiting this right to institutional lenders. Also, consider limiting participation or syndication to instances in which the originating lender retains control over the loan.

6. Default and Rights to Cure

A ground lease is a lease. At some point the landlord will have the right to declare a default and use his state's eviction procedure to recover possession of the property.

However, one ubiquitous feature of ground leases is a mechanism giving the lender the ability to keep the ground lease in full force and effect if the ground lessee defaults. The ground lease typically requires that the ground lessor simultaneously deliver any notices of default to the ground lessee and the lender, and it should expressly provide that no notice by the ground lessor to the ground lessee will be considered effective if not simultaneously delivered to the lender.

Some lenders also request a second notice after the ground lessee has failed to cure the underlying default, though lessors legitimately object to this concept on the ground that lenders should not get "two bites at the apple".

7. New Lease

The inability to eliminate every right of termination of a ground lease is problematic for any lender. As added protection in the event the ground lease is terminated before its expiration date, a financeable ground lease may also contain provisions requiring the ground lessor to enter into a new ground lease with the lender on the same terms and conditions as the original ground lease and would be effective for the balance of the term of the original ground lease. Though an imperfect solution, it preserves some ability of the lender to realize the value of its collateral.

8. Renewal/Extension Options

Though the preferred structure is that the lease term will survive the maturity of the financing, if the ground lease expires prior to the maturity of the ground lease financing, the lender may require the existence of renewal/extension options coupled with some level of ground

lessor protection, such as notice from the landlord to trigger a requirement for exercise, or automatic exercise absent a non-exercise notice from tenant.

This is a potential pitfall. Often, lenders will rely on language requiring notice from the ground lessor before the ground lessor terminates the lease. However, under the law of many states, an option is not a vested real estate right unless and until it has been duly and properly executed by the ground lessee. If the ground lessee in such a jurisdiction fails to exercise the option, the lease expires by its own terms. In that instance, the landlord is not "terminating" the lease when it seeks recovery of the leased premises.

For this reason, ground lease lenders will insist on a structure that prevents the accidental loss of an option, such as a requirement for notice to the tenant and lender by landlord before a lease can expire. The basic concept is that it must be impossible to lose the lease due to inadvertence or mistake.

9. Anti-Merger Clause

If the ground lessee acquires the fee interest in the property, it is arguable that the leasehold estate and fee estate have merged together (i.e., that the lesser estate (the leasehold estate) has been absorbed into the greater estate (the fee estate)), resulting in the extinguishment of the ground lease. If a ground lease gives the ground lessee an option to acquire the underlying ownership interest in the property, a prospective ground lease lender will most likely require the ground lease to contain a provision specifically prohibiting the merger of the leasehold and ownership interests in the property to preserve its security interest in the ground lease.

10. Changes in Ground Rent

Because most ground leases have long terms, ground lessors often demand rental adjustment clauses in the ground lease to assure that the ground rent will remain an approximation of the fair market rental value of the leased premises throughout the term. Lenders, who by their nature desire certainty, closely scrutinize such provisions, and the result is that the less quantifiable and more periodic the potential rent increases, the more stringent the loan underwriting. Lenders may be more willing to finance ground leases containing rent escalators if index increases are capped and limited to five year periods. A "ratchet" increase, which does not protect the ground lessee from economic downturns, may be more palatable to a lender if based on a lower percentage of total rents and a greater number of years.

11. Estoppel Certificates/SNDA

A ground lessee who anticipates seeking leasehold financing would be well-served by at least obtaining a provision requiring the ground lessor to provide an estoppel certificate to a leasehold mortgagee from time to time.

In addition to obtaining the usual assurances from the ground lessor (the ground lease is in full force and effect; neither party is in default thereunder; etc.), a lender can attempt to use an estoppel certificate to obtain the ground lessor's consent to mortgagee protection provisions that are not in the ground lease. For example, the ground lessor could represent and warrant to the lender in an estoppel certificate that, notwithstanding any provision of the ground lease, the

written consent of the ground lessor will not be required to permit the lender to enforce its rights under the leasehold loan documents or to obtain possession of the leasehold estate by foreclosure. In addition to the estoppel, the ground lessee's lender should consider, in appropriate circumstances, the SNDA between the ground lessee, the ground lessor, and the fee mortgagee.

In my practice, I have used the ground lessor SNDA/estoppel process to modify the ground lease, with modifications to apply only while the financing is outstanding.

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