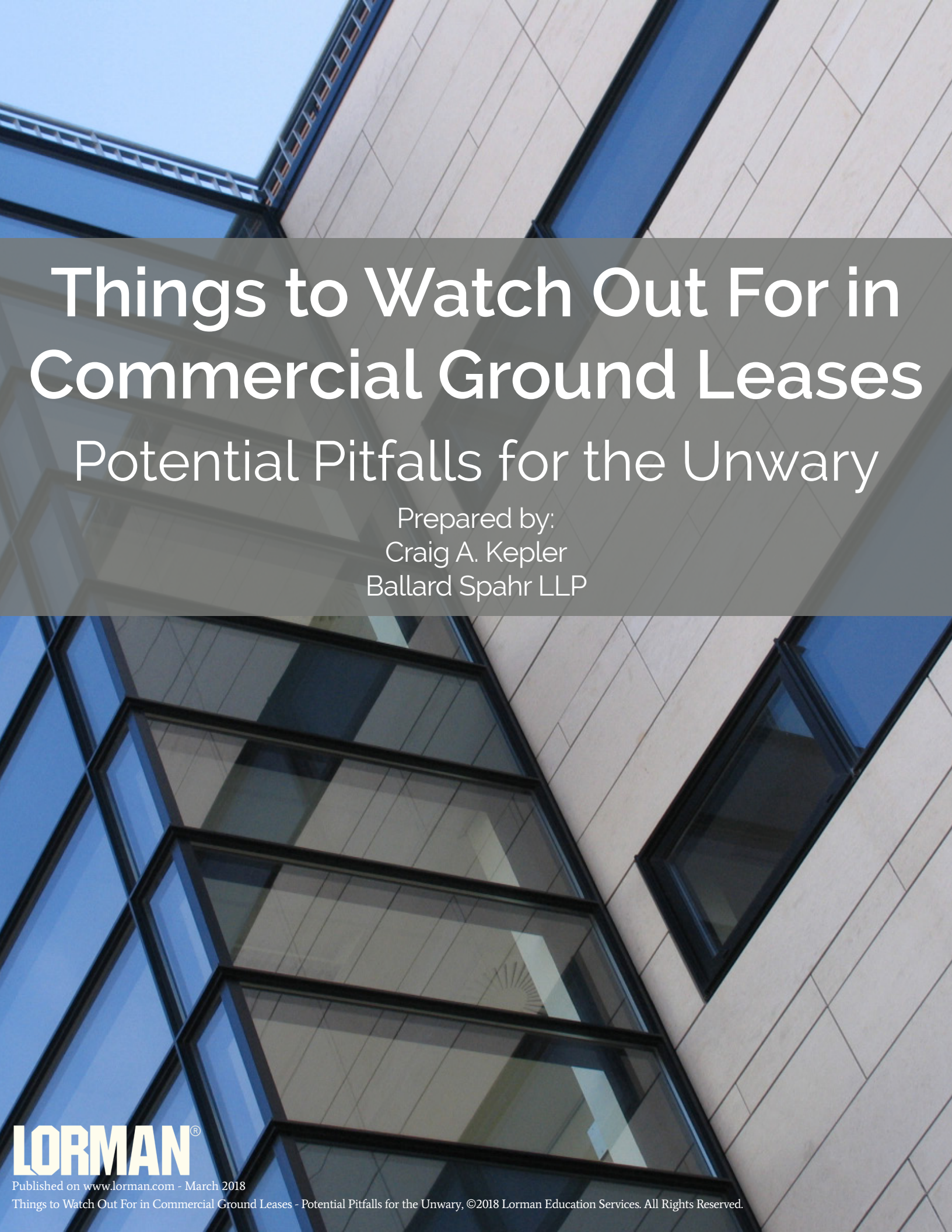

Things to Watch Out For in Commercial Ground Leases

Potential Pitfalls for the Unwary

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THINGS TO WATCH OUT FOR – POTENTIAL PITFALLS FOR THE UNWARY

Written by Craig A. Kepler, Lindquist & Vennum LLP

Since ground leasing is typically something the average landholder does only once in his life, he is at a disadvantage with respect to understanding business risks of ground leasing from the perspective of the ground lessor, in comparison to a sophisticated ground lease tenant (such as a national franchise big box or fast food operator) with multiple ground lease experiences. Below are a few commonly overlooked issues.

A. Exit Strategy

As noted above, ground leases are long term deals, long enough to enable amortization of the construction and development costs. This means that it is likely also long enough to see the end of the useful life of capital items such as the roof or HVAC.

Of all of the areas of conflict in ground leases, the conflict most commonly seen by this author has to do with exactly what will be turned over to the ground lessor upon expiration of the lease.

At the outset of the lease, the parties should discuss this and reach an express agreement. Often, the ground lessor is willing to accept the property in its as-is condition at the end of the term.

However, if the lessor intends to receive, at the end of the ground lease term, a functioning, useable structure, this needs to be

specified in the ground lease. More important, the ground lease should include a mechanism for ensuring that this will be done. In the final year of a ground lease, a ground lessee will have little incentive to invest a large amount of capital into a property that will soon be of no use to it. Courts may have little sympathy for claims by a ground lessor when presented with evidence of the cumulative amounts paid by the ground lessee over the life of the lease.

On the other hand, perhaps the lessor wants its raw land back, restored to more or less its unfinished or natural condition. Again, how will this happen? Razing an aged structure can be expensive.

Furthermore, if the lessee is a single purpose entity, it may be essentially a shell by the end of the lease. If these types of lessee obligations will be included in the ground lease, the lessor should consider some measure of security for these types of obligations, such as a portion of rent set aside to fund a reserve.

B. **Environmental Indemnities**

Ground lessees will try to get the lessor to indemnify or reimburse the lessee for pre-existing environmental conditions. The argument is that if the lessor were to develop the property himself, he would have to address environmental conditions. Thus, since the ground lessee is essentially developing the property for the lessor, who enjoys the rent stream without the work of developing, the ground lessee should not be saddled with the cost of remediating.

Obviously the issue will be controlled by the economics of the deal. If the ground lessee is enjoying a favorable rent, it is fair to ask him to bear the risk of pre-existing environmental matters, and vice versa.

If the ground lessor does agree to bear the expenses associated with pre-existing environmental conditions, keep in mind that environmental laws are complex. There is often more than one "correct" or "legally compliant" method of addressing an environmental condition. If the lessee has the equivalent of an open checkbook to spend the lessor's money, the lessee will opt for the most convenient and speedy method, even if it happens also to be the most expensive.

A well drafted provision on this issue should call for the input of a neutral third party to determine the scope and method of addressing any particular environmental condition. There should be a procedure for input by both lessor and lessee, and perhaps even a dispute resolution mechanism that is discreetly focused on only this particular dispute.

C. **New Accounting Rules**

This seminar will not get into accounting rules in depth. However, it should be noted that, in approximately 2009, new accounting standards were promulgated that affected, among other things, how lease payments are calculated and amortized. Essentially, the lease is now carried on a tenant's books as a liability, and on a landlord's books as an asset, with the value based on a present value calculation of the sum of the lease payments over the term of the lease.

Given the duration and scope of a ground lease, both a lessor and a lessee contemplating a transaction of this nature should consult with their CPA or tax counsel to discuss this.

D. **Recordation**

Ground lessees will almost always wish to record a memorandum of their lease. However, keep in mind that, once recorded, ground lease memoranda are difficult to un-record. This is because by the time the ground lease expires, the individuals who negotiated it are often no longer in the picture. The succeeding parties have forgotten about the recorded memorandum. Nobody thinks about it or even knows about it until often much later, typically when the property owner is seeking to sell or refinance and somebody conducts a title search. By then it can often be too late. The ground lessee might have dissolved or gone out of business.

After the decision in *Precision Industries, Inc. v. Qualitech SBQ, LLC (7th Cir. 2003) 327 F.3d. 537*, it is clear that some form of memorandum must be recorded. *Qualitech* examined the relationship between two sections of the Bankruptcy Code – Section 363(f) and Section 365(h). Section 363(f) permits a debtor to sell property of the estate in bankruptcy "free and clear of any interest in such property" if at least one of five statutory conditions is satisfied. 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 (see above).

The issue before the Seventh Circuit in *Qualitech* was whether a trustee or debtor could use a sale under Section 363(f) to extinguish a lessee's possessory interest, notwithstanding the provisions of Section 365(h). Before *Qualitech*, no circuit court had addressed this precise issue. However, most lower courts held in reported cases that the protections afforded to a lessee by Section 365(h) prevailed over the debtor's right to sell free and clear of interests under Section 363(f).

These lower court decisions, in turn, led to the prevailing view that a debtor could not sell property in a bankruptcy free and clear of a lessee's possessory interest in such property.

Qualitech decided this issue the obverse of this prevailing view. One fact in *Qualitech* was that the ground lessee failed to submit a timely objection to the 363 sale. This procedural error made it easy for the court to rule as it did. I'm not aware of a reported decision specifically applying *Qualitech* in the 8th Circuit. However, it is still out there. There have been various efforts to amend section 363 to fix this issue but none have been successful.

After *Qualitech*, it is not guaranteed that recording a memorandum of lease will prevent a sale free and clear of the lessee's interest. However, a recorded memorandum of lease, together with a well crafted SNDA with any fee lender will (1) protect the lessee with respect to any transfer to the fee lender, and (2) create the ability for the lessee to require adequate protection payments as a condition to a 363(f) sale by the ground lessor.

For this reason, this author suggests that if a memorandum will be recorded, it should state on its face that it expires on the date the lease itself expires.

E. **Redemption**

In some states, ground lessees may have a right of redemption in the event of a default and eviction. This can vary a great deal from state to state and is very specific to state law. It should be looked at in every instance by a lawyer from the state in which the property is located. The following is a very generic example of a provision to waive this right:

Waiver of Right of Leasehold Redemption. The Lessee hereby expressly waives, for itself and any transferee or successor, any and all right of redemption in the event the Lessee is dispossessed by court action. WITHOUT LIMITING ANY OTHER PROVISIONS HEREIN SET FORTH, THE LESSEE EXPRESSLY WAIVES ANY RIGHT TO WRITTEN NOTICE OF CANCELLATION AND TERMINATION OF THIS OCCUPANCY AGREEMENT UNDER SECTION _____ OF _____ STATUTES AND EXPRESSLY WAIVES ANY RIGHT OF REDEMPTION UNDER _____ STATUTES. BY ACCEPTANCE OF THIS OCCUPANCY AGREEMENT, THE LESSEE ACKNOWLEDGES THAT HE/SHE HAS READ AND UNDERSTOOD THE FOREGOING PROVISION.

F. **State Laws Changing Deals Based on Equitable Notions**

There have been circumstances where states the terms of a ground lease based on equitable principles. For example, in Hawaii many large condominium projects are built on ground leases with terms of 99 years. Many of these leases date back to the early part of the 20th century, meaning that their terms were reaching an end in the early aughts. However, by then (1)ºthe condominiums themselves had appreciated a great deal in value, and were often occupied by elderly, stable owner bases, and (2)ºin the meantime, the fee owner had received a handsome sum in rent from the condominium. To stop speculation in the sale of these properties near the end of the ground lease term, the Hawaii legislature passed a statute giving the condominium association a limited right of first refusal on the land.

Even further than that, in the early 1990's one municipality in Hawaii began using its power of eminent domain to assist condominium associations with acquiring fee title to their previously ground leased property. The constitutionality of this practice was upheld by the 9th Circuit Court of Appeals in 1992 in *Richardson v. Honolulu*.

I point this out to illustrate that over the long term of a ground lease, depending on changing political climate, there may be outside forces that impact the lease and force it to change.

G. **Property Taxes; Reassessment**

Though this seminar is not intended to be state specific, there is an aspect of ground leasing under California law that should be pointed out. Under California's "Prop 13", real property is not reassessed for property tax purposes unless and until there has been a "transfer." Most people understand that a sale is a "transfer," but fewer people remember that a lease with a primary term of 35 or more years is also a "transfer," Not only is such a lease a "transfer," it is a "transfer" at both the commencement and the termination of the lease.

This same consideration applies to any other voluntary sale of the property. A ground lessor under a long-term lease that does not contain an index for property taxes could find himself paralyzed and unable to sell the property because of the cost of taxes on reassessment.

One way around this is to require the ground lessee (tenant) to pay the property taxes. Many ground leases do contain this requirement. In such a case, however, the ground lease also generally

gives the tenant the right to contest assessed value and otherwise initiate proceedings to affect the tax rate. This can have residual effects on the property owner after the lease is expired.

Some long term leases for oil or mineral extraction set the base rent as a percentage of the proceeds of the extracted oil or minerals. If the land is a poor producer, this can mean that the payment is small. If the land is owned in an area that appreciates in value, the monthly rent might not be enough to cover property taxes. Thus, at a minimum, rent should at least equal taxes.

H. **Other Legal Changes**

One example of an unforeseen set of legal changes that affects ground leases has to do with the applicability of a "gold clause." Gold clauses were common in ground leases in the late 19th and early 20th century, especially in the Western U.S. These clauses indexed the increasing ground lease payments to the value of gold. A typical such clause specified the amount of rent to be paid and stated that "[a]ll of said rents shall be paid in gold coin of the United States of the present standard of weight and fineness."

However, in response to the depression and the Roosevelt administration's overhaul of the monetary system, the Federal government banned most forms of private ownership of gold and, along with this, in 1933, the Federal Government passed a law invalidating gold clauses. This had the effect of freezing ground lease rents at artificially low levels.

In 1977 the federal law was again changed. Under the new law, newly written gold clauses would be enforceable. In addition, older ground clauses that had been invalidated under the old law could be

re-vivified if there were a "novation". Ground lessors began to get aggressive about asserting that certain changes relative to ground leased land, such as foreclosures by the ground lease lender, constituted a "novation."

Though gold clauses are not widely used in modern ground leases, this is pointed out here to illustrate the type of change that can occur over the long term of a typical ground lease. There have been a few highly contentious cases involving novations that allegedly re-vivified a dormant gold clause, such as the case of *Jamaica Avenue, LLC* v. *S & R Playhouse Realty Co. In such cases, generally the property owner is seeking a significant increase in rent (in Jamaica Ave. the rent would have increased by 75 times), which seems like a harsh result for the tenant, but the tenant is seeking the ability to control the property over a very long term for a rent that is well below market for the property.*

I. Partial Subletting/Splitting the Parcel

A ground lessee who contemplates the possibility of having more than one occupant on his land ought to specify this in the sublease clause. If the ground lessee contemplates a legal parcel split, this right should be specified in the ground lease. Otherwise, the ground lessor will probably be within its right to withhold consent to this action.

J. Impossibility/Impracticability

Though a ground lease, as noted above, typically includes a due diligence period, the parties should pay attention to the wording of the impossibility/impracticability provision. For example, a tenant may find, after waiving contingencies, that there is an area on the land

where the existing soils would not support the structure. Whether this is the sort of "impossibility/impracticability" that will support a tenant cancellation of the lease is purely an issue of lease construction.

K. **Consideration For Due Diligence Period**

Though slightly outside of the subject matter of this presentation, the California case of *Steiner v. Thexton* is potentially troubling in a ground lease setting. *Steiner* involved a developer-friendly contingent purchase agreement with a nominal earnest money deposit and a lengthy due diligence period. The trial court held that the contract was an option and that the nominal down payment was not sufficiently substantial consideration for it, thus entitling the seller/owner to cancel the contract (presumably because seller had a better offer from another buyer). The Supreme Court of California ultimately reversed, partially on the basis that the buyer had invested considerable amounts in the due diligence process, which was a form of reliance that made the contract enforceable.

However, in the ground lease context, frequently the ground lessee makes no earnest money deposit at all prior to the expiration of the due diligence period. Query how this dispute might be decided if it were to arise in this context. Right now it will probably not be an issue, but if we find ourselves again in a sharply increasing market it will likely come up.