

Ground Leases: *Some Basics, Some Specifics and How to Make Them Financeable*

Prepared by:
Eben P. Clark
BakerHostetler LLP



LORMAN®

Published on www.lorman.com - September 2018

Ground Leases: Some Basics, Some Specifics and How to Make Them Financeable, ©2018 Lorman Education Services. All Rights Reserved.

INTRODUCING

Lorman's New Approach to Continuing Education

ALL-ACCESS PASS

The All-Access Pass grants you **UNLIMITED** access to Lorman's ever-growing library of training resources:

- ✓ Unlimited Live Webinars - 120 live webinars added every month
- ✓ Unlimited OnDemand and MP3 Downloads - Over 1,500 courses available
- ✓ Videos - More than 1300 available
- ✓ Slide Decks - More than 2300 available
- ✓ White Papers
- ✓ Reports
- ✓ Articles
- ✓ ... and much more!

Join the thousands of other pass-holders that have already trusted us for their professional development by choosing the All-Access Pass.



Get Your All-Access Pass Today!

SAVE 20%

Learn more: www.lorman.com/pass/?s=special20

Use Discount Code Q7014393 and Priority Code 18536 to receive the 20% AAP discount.

*Discount cannot be combined with any other discounts.

Ground Leases: Some Basics, Some Specifics and How to Make Them Financeable

Written by Eben P. Clark - June 29, 2018

Ground leases are fairly common but sometimes overlooked property interests. A succinct but adequate definition of a ground lease was articulated by Herbert Thorndike Tiffany (Tiffany on Real Property § 85.50 [3d ed.]) as follows:

[A]n arrangement in which the fee owner of real property leases to a leasehold tenant many or all of the rights of the beneficial ownership of such real property held by the fee owner. Typically, in a Ground Lease, the leasehold tenant will, for the term of the lease, maintain almost autonomous control over the real property leased, including the right to construct improvements, assign, sublease, and obtain leasehold mortgage financing.

Landlords often use ground leases to (i) retain ownership of the real property for heirs/estate planning purposes, (ii) avoid realizing capital gains if holding with low basis, (iii) create an income stream or (iv) create a financing tool for improvements. Tenants might find a ground lease attractive to (i) create a financing tool for a project and improvements, (ii) reduce financial barriers to entry in the project or (iii) obtain tax deductions for the payment of rent.

In any context, the tenant under a ground lease will typically be interested in constructing improvements on the real property and

obtaining financing to do so. But how can a tenant borrow against real property it does not own? The key is to craft a lease that a lender will view as a reliable and recoverable asset.

The ownership of real property can be understood as the ownership of a group of rights or “bundle of sticks” (the right to occupy, the right to exclude others, the right to improve, the right to encumber, etc.). In granting a lease, the landlord gives the tenant many but not all of the sticks. This bundle of rights itself becomes transferable, and the tenant can pledge them as collateral. Therefore, many lenders will accept a correctly drafted ground lease as collateral, and such a lease is referred to as a financeable ground lease.

There are some common attributes to a financeable ground lease. First, the duration must be sufficient to cover the term of the loan. This can be 30 or more years on an amortized loan – or longer if the loan is not fully amortized. Some states have restrictions on how long a lease can run before it will be considered a sale, but these can often be avoided through renewal options. Second, a financeable ground lease is documented more like a sale in order to solidify the interest. In a financeable ground lease, there will typically be (i) heightened representations, warranties and indemnities by each party, (ii) significant restrictions on the termination of the lease (even in the case of a breach), (iii) title insurance, with the leasehold as the insurable estate and (iv) a memorandum of lease that is recorded.

There are also specific lender’s rights that will be required in a financeable ground lease. Some of the critical lender provisions are:

- Preservation of the Priority of the Tenant’s Rights and Lender’s Lien.
A financeable ground lease will include restrictions on the landlord

granting any mortgage or encumbrance that may interfere with the tenant's use and rights. Lenders will require a subordination and non-disturbance agreement (SNDA) for all existing or future lien holders.

- **Right to Cure/Perform.** A financeable lease will require the landlord to give the lender notice of any alleged default under the lease and the right to cure any default on the tenant's behalf. The lender will also be granted an additional period to cure on top of the tenant's cure period, which will be extended if the lender commences foreclosure or if the lender's rights are otherwise delayed. The lender may also be granted the right to perform on behalf of the tenant and take possession of the property during this period.
- **Lender's Right to Acquire/Transfer Interest.** The lease should provide that the lender has the express right to acquire and sell all of the tenant's rights in a foreclosure without the need for consent from the landlord. The lender may want to work with the landlord in any foreclosure situation, but must have the flexibility to liquidate the property in the case of a default by the tenant. These rights should be expressly carved out from any other restrictions on the tenant's right to assign the lease. Lenders can also be granted options or the right of first refusal to acquire the rights of either the borrower or landlord.
- **Restrictions on Termination.** For the uninitiated, this is one of the more surprising aspects of a financeable ground lease. There are often significant restrictions on the landlord's right to terminate the lease at all. Many landlords cannot fathom a lease with an outright prohibition on the right to terminate. For the landlord's benefit, these provisions may distinguish between monetary and

nonmonetary defaults, and may require any lender to pay amounts due while limiting the landlord's rights on a nonmonetary default.

- **Lender's Rights in Bankruptcy.** A financeable ground lease will generally provide that the bankruptcy of the tenant is not a basis for termination of the lease. Because the enforceability of these provisions has been called into question, financeable ground leases very often have a second provision that grants the lender the right to immediately enter into a new lease with a landlord on the same terms as the original lease if a trustee in bankruptcy attempts to avoid the lease.

A financeable ground lease must be acceptable to lenders, and this requires the creation of a uniquely durable lease with third-party rights and controls that are uncommon in other leases. Many of these provisions come as a shock to the landlord. While landlords and many of their attorneys will find these provisions odd, most lenders will require them, and the project will depend on including them in the lease. Therefore, when considering such a transaction as a landlord, tenant or lender, it is critical to have counsel with experience in this unique property interest.

The material appearing in this website is for informational purposes only and is not legal advice. Transmission of this information is not intended to create, and receipt does not constitute, an attorney-client relationship. The information provided herein is intended only as general information which may or may not reflect the most current developments. Although these materials may be prepared by professionals, they should not be used as a substitute for professional services. If legal or other professional advice is required, the services of a professional should be sought.

The opinions or viewpoints expressed herein do not necessarily reflect those of Lorman Education Services. All materials and content were prepared by persons and/or entities other than Lorman Education Services, and said other persons and/or entities are solely responsible for their content.

Any links to other websites are not intended to be referrals or endorsements of these sites. The links provided are maintained by the respective organizations, and they are solely responsible for the content of their own sites.