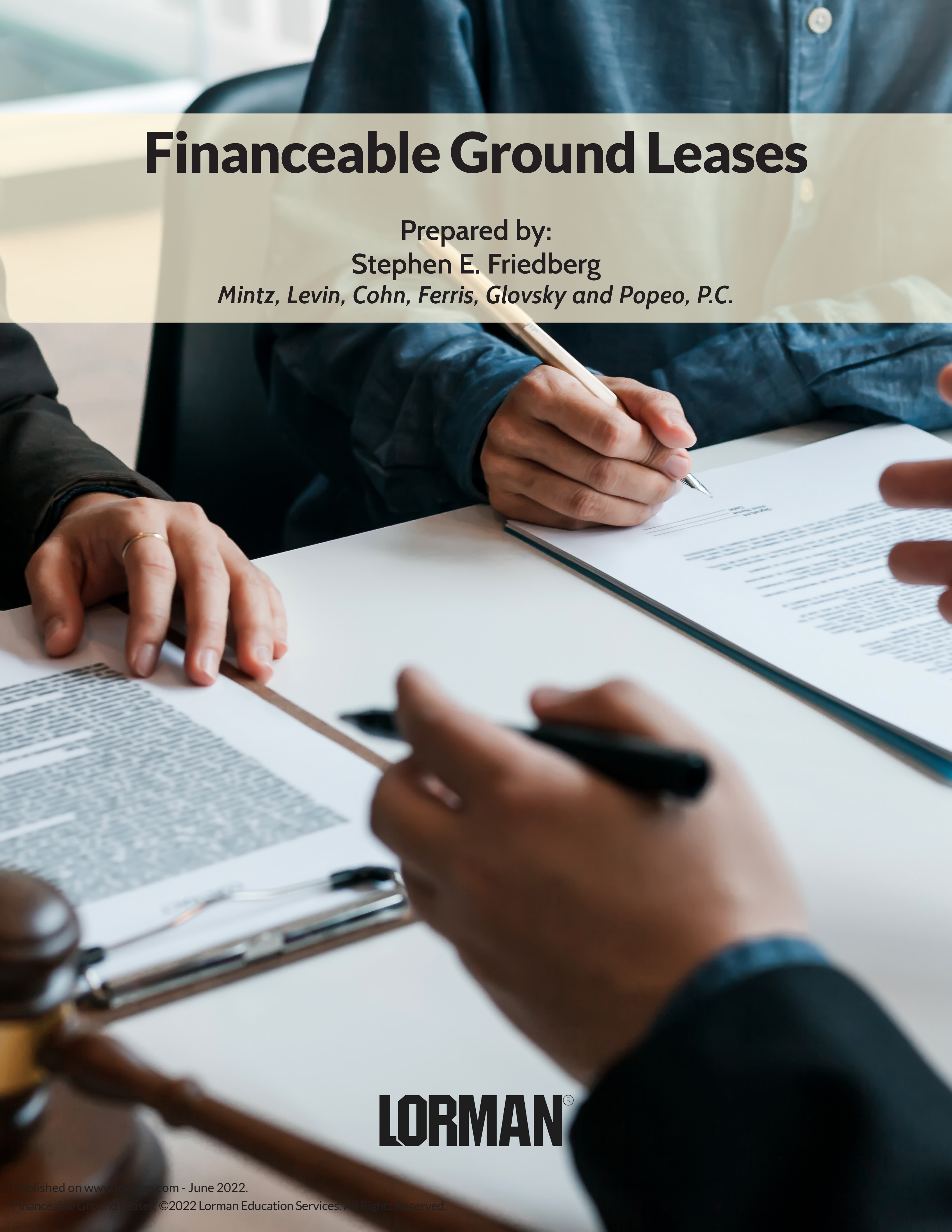

Financeable Ground Leases

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FINANCEABLE GROUND LEASES

Introduction

The purpose of this white paper is to explain the unique nature of a financeable ground lease. In order to do so, I will highlight some of the differences between a space lease and ground lease, because most of us have experience with space leases in office, industrial, retail and other properties (regardless of whether the space lease is gross or net and the level of net, although ground leases are generally triple net). In a typical space lease, even if the space includes entire building, the landlord is the owner of both the building and all improvements, with the exception of the tenant's personal property. In a space lease, some or all of the buildout of tenant's space may have been financed or performed by the landlord (or in some instances by the tenant), but other than personality, any improvements that are affixed to the realty (i.e., are permanent), are landlord's property, regardless of who paid for it. Accordingly, in a space lease, not only does the landlord own those improvements, in addition to the structure of the building, but its fee mortgage will have a lien on such property. Because of that, even if tenant was allowed to obtain a leasehold mortgage in a space lease, there would be no real estate interest that the leasehold mortgage could attach to, other than the right to possess the premises during the term (although very few space leases permit such financing, in any event).

In contrast, in a ground lease, either the tenant constructs the improvements with its own funds or that of a leasehold mortgagee or has purchased the improvements erected on an improved property, thereby separating the estates in the property into a fee estate, which includes a right of the landlord to receive the rent over the term (on a triple net basis) and to the return of the improvements at the end of that long term (commonly designated as a "reversionary estate") and a tenant's leasehold estate, in which the tenant has both the right to occupy the ground and owns the improvements located on it (including the building and building equipment). This creates an estate on which a leasehold mortgagee can grant a mortgage lien. Obviously, there can be a ground lease in which no improvements have been made or required to be made, but that is not really the subject of this presentation and is effectively land banking of property.

What some of you may know is that many significant buildings in urban areas have been ground leased. This is common across the country and includes many iconic buildings (including such buildings as the Chrysler Building, which I will discuss a bit later when I discuss rent resets).

Ground leases often have terms of 99 years and because they are triple net have a similarity to a fee estate for years, other the obligation to pay the rent to the fee owner.

Another way to look at a ground lease is that the landlord gets to finance the ground lease rental stream while the tenant gets to finance the improvements. In the case of a ground lease of an existing building, the landlord accomplishes what is effectively a 100% financing accomplished by the sale of the improvements (albeit, with a reversionary interest in the far future), as well as the ground lease rental stream (which can be, in turn, financed in a fee mortgage). The tenant gets to either use the improvements for its own purposes or more commonly to rent it to third parties and bank on the upside of increases in sublease rents over the term.

Ground lease tenants are then able to finance their interest in the owned improvements which, in most instances, far exceeds the value of the underlying land. Because a mortgage on a ground lease tenant's leasehold interest carries more risk to a lender than that of a loan to a fee owner, due to the possibility of a default by the ground tenant, leasehold mortgagees who provide construction or permanent loans on leasehold estates have created a complex set of provisions that must be adhered to in order to protect their interest in the property. These leasehold mortgage interests are also governed by rating agencies, such as Moody's, that have issued various rulings and directives as to what has to be included to protect a leasehold mortgagee.

The focus of this presentation has more to do with converting an improved parcel real estate to a fee and leasehold estate, because that is becoming increasingly popular and there are industry players such as Safehold, a REIT, with its iStar ground lease program, that are exclusively focused on this capital vehicle. However, regardless of the existence of improvements at the onset of the term, the principles of ground leasing remain the same.

Creation of the Estates

In an instance in which an unimproved parcel of land is ground leased to a tenant, the ground lease has to clearly define the landlord's estate and the tenant's leasehold estate. The ground lease should also provide that the tenant, rather than the landlord, has the right to depreciate any improvements it builds on the premises and whether the tenant is required to make such improvements (and the parameters thereof).

If an improved parcel of real estate is being ground leased, then in addition to delineating (and separating) the two estates, the improvements have to be conveyed to the tenant. This is generally done by an improvements deed. One practice note is that the recording of an improvements deed will generally trigger a transfer tax, in those states in which there are transfer taxes, in addition to any transfer taxes that may be imposed with respect to the term of the lease, in those states in which there are transfer taxes on leases (which term thresholds ranging from as little as seven years to as many as 49 years). Aside from determining the amount of the tax, a question is often raised as who will pay the tax on both the improvements and the ground lease (i.e., whether the transfer taxes are split, paid by the landlord or the tenant, or paid in accordance with the custom in the area in which the transaction is occurring). As an example, I am working on a ground lease now in which the relevant jurisdiction initially indicated that it might impose transfer taxes on the improvements deed and ground lease equal to 150% of the value of the property; so this issue must be identified at the outset, thought through, structured carefully and negotiated

As discussed above, landlord's estate is called a reversionary estate. Like it sounds, the landlord has no obligations with respect to the property during the term (other than to comply with any obligations under any fee mortgage), and unless a tenant is evicted from the property, landlord's estate is limited to a right to collect rent and its interest in both the land and the improvements when the term ends upon its expiration.

The leasehold estate is a hybrid estate, because of tenant's ownership interest in the improvements and the need to protect and benefit from that interest over an extremely long period of time. That changes the balance that you normally see in a space lease in which the landlord has a primary interest in a building and the underlying property.

Practice Tip: As you can imagine, most ground leases are quite complex and lengthy and one way to make them more user-friendly is to have a comprehensive definitions section.

Due Diligence/Approvals

Because the tenant is either purchasing a building and other existing improvements or leasing land that it will improve, it should perform due diligence on the real property, to the same extent as the tenant would perform if it was purchasing a fee interest in the property. Because the focus of this seminar will be more about ground leasing of improved properties, that generally means that there will be a purchase and sale agreement for the improvements that is just as comprehensive as an agreement to purchase a fee interest. Due diligence will generally include examination of title, survey, environmental and physical condition of the property (including its structural and nonstructural components), zoning (including any additional development rights), violations, and existing space leases. In a ground lease of unimproved property, this would also include obtaining geotech reports.

Additionally, if the property is unimproved or the improvements require replacement or substantial renovation, the ground lease will typically also contain a governmental approvals or permitting period.

Accordingly, there are two simultaneous transactions being undertaken when a ground lease is contemplated. At the same time as the tenant/buyer is performing its due diligence (and seeking any required approvals), it should also line up a leasehold mortgage and deal with the requirements of that mortgagee, which we will examine further below (but which I will add will be a complex and often heavily negotiated undertaking). From both a landlord's and tenant's perspective, it should be understood that the leasehold mortgagee and its counsel will often weigh in on a number of terms of the ground lease.

Commencement Date/Closing

When the due diligence and any required approvals are completed, the closing will occur and the commencement date will be established. At the closing, landlord will provide tenant/buyer with an improvements deed (with or without a reverter right at the end of the term), a bill of sale, an assignment of the existing space leases; and other typical closing documents will be entered into by the parties. In addition, estoppels will typically be obtained from major subtenants (the tenants who leased space from the landlord and will now be subtenants of the new ground tenant) and a recognition agreement would be given by the landlord to major subtenants (who would also receive an SNDA from a leasehold mortgagee). Additionally, both the landlord and tenant (as well as any mortgagees) will obtain title policies. At that point, a deed, memorandum of lease, any leasehold mortgage, and then any fee mortgage would be recorded, in that order. This is a vital component of a ground lease because any fee mortgage must be subordinate to the ground lease and any leasehold mortgagee has to make sure that its interest in the lease (and thereby the improvements) is superior to that of the fee mortgage. The best practice is to expressly state this subordination in the granting clause of the ground lease.

Tenant/Guarantor

Tenants under most leases are single-purpose entities, and that is no different for a ground lease. Guarantees are not that common in-ground leases unless the tenant is developing or constructing a new building on the site (in which instance the guaranty is usually limited to a payment and performance completion guarantee of the construction, except in retail ground leasing in which guarantees are common.) One way to look at the equity stack in many ground leases is that in the case of the purchase of existing improvements, the equity of the tenant is the value of the building that has just been purchased.

Term/Transfer Taxes

As previously mentioned, the term of many ground leases is 99 years (although there are shorter terms (e.g. 20 or 25 years, with multiple extension options, so that most ground leases are 50 or more years). Although some retail tenants prefer a shorter term, most want a 99-year term, so that they can get full value of their purchase (or construction) of the improvements (and are able to finance the leasehold estate over the term). Regardless of the term, an important issue to consider is transfer taxes. Transfer taxes will generally be payable in connection with the sale of any existing building. In addition, a fair number of jurisdictions impose transfer taxes on the creation of leases that exceed a threshold term of years (e.g., New York-49 years, California-35 years, Pennsylvania-30 years. and Maryland-7 years, and such thresholds generally include option terms, whether or not exercised). Although there are states where there are no transfer taxes, this is less common in many of the major urban areas in which a majority of ground leases are most commonly entered into. Those taxes should be considered while the lease is being negotiated (including consultation with local counsel, if necessary, and with a title company,) and an agreement should be reached as to who will be responsible to pay such taxes. Please note that leasehold mortgage rating agencies require or strongly prefer a long term that exceeds the mortgage term by at least 10-30 years, depending on the agency.

Rent

The initial rent under a ground lease is negotiated as if the land is unencumbered by the lease and generally increases by fixed amounts or by increases in CPI, with or without a cap. However, from a landlord's perspective (and industry practice) this will not likely take into account an increase in the value of the land (and the market). Accordingly, most ground leases include rent resets periodically, often every 20 or 25 years equal to a percentage of the fair market value of the land (often between 5-7% of such value) or based on a fair market rental approach (which is becoming more common). If a rent reset is present in a ground lease, a landlord would want the fair market value to be based on the value of the land unencumbered by the lease and by liens or encumbrances (or an appraiser will generally consider those items and the rent will be lower); a tenant may argue to the contrary (because the appraiser can look to the highest and best use of the land), so there is tension between the parties' positions. A mechanism should also be established for the appraisal (whether by a single party or two/three parties and whether based on baseball arbitration, majority rule, etc.).

Net Lease

Ground leases are almost always triple net leases, with the tenant bearing responsibility for real estate taxes and all expenses of operating, insuring, maintaining, and repairing a property and its improvements, including interior, exterior, structural and non-structural maintenance and improvements. This generally applies to environmental conditions, so a careful assessment must be made of any existing conditions at the site. Additionally, from a landlord's perspective, a standard should be set for tenant's maintenance of the improvements.

Use

The permitted use in a ground lease is important because the landlord wants to make sure the property is used for a purpose that maintains or improves its value. Rating agencies (governing leasehold mortgages) and leasehold mortgagees prefer the broadest use clause with the highest mortgage value and a tenant can make an argument that the current use of a building may not be the highest and best use over a 99-year term. However, the landlord generally wants to make sure that its property is maintained at the same or a better standard that it is being maintained at as of the date of the ground lease and that the tenant, is able to lease the property to the subtenants. A landlord would likely also be concerned about a property's leaseability to third party tenants if landlord is required to take back the property after a tenant default that the tenant or a leasehold mortgagee doesn't cure. If a landlord agrees to let a tenant change a property's use, landlord should set limits on such change, including requiring evidence that such change would increase the value and rentability of the improvements (and provide security for payment of the ground lease rent while any alterations are made).

Alterations/Replacement of the Existing Building

A ground lease tenant will want maximum flexibility in being able to alter a building to maximize its value for its own use or that of any subtenants. Landlord should provide tenant with a fair amount of flexibility in making alterations, provided the value of the improvements is not affected. Most ground leases require the value of the replaced improvements (unless obsolete) to be at least equal to those that are being altered or replaced. A more interesting issue is if, during the 99-year term, the tenant wants to replace the building. Although part of landlord's security is the fact that there will be an existing building in place that landlord could take over if the tenant defaulted, this would not be the case if the tenant demolished the building and failed to complete the new building or diminished the value of the replacement building. For that reason, there often both strict parameters and rigorous protections for landlord when a building is being replaced, including requiring letters of credit, guarantees, and/or other security and also requiring landlord's approval for the replacement of the building. In some instances, landlords also require that the tenant demonstrate that the value of any new building that is proposed to replace an existing building be greater by some percentage than that of the building it replaces and would increase the potential rents (and some landlord ask the tenant to share a portion of any increased rents). During the period of construction, the tenant would be required to continue to pay the rent under the ground lease despite none of the subtenants being responsible for rents and some landlord would require security for this obligation from a parent or other deep-pocketed party. This is often a hotly contested and negotiated portion of the lease.

Casualty

Given the triple net nature of a ground lease, any casualty to a building during the term does not affect tenant's obligation to pay rent. Moreover, virtually all ground leases require the tenant to rebuild the building regardless of when the casualty occurs. However, there may be negotiation about what happens during casualty at the end of the term. If a landlord agrees to let a tenant elect to terminate the lease and not to rebuild during the last few years of the term, the landlord should require that tenant pay over the insurance proceeds for the reconstruction to landlord and make up any deficiency if a leasehold mortgagee receives some of the proceeds (and may require security for any deficit as a condition to allowing tenant to make such election). This required is rooted in a landlord being able to benefit from its reversionary estate in the improvements (and to ensure they will be maintained and returned in good condition). This also ties into the requirement that tenant maintain casualty insurance in the full replacement value of the improvements, with a limited deductible. Of course, the leasehold mortgagee will also likely require such insurance to be maintained.

Condemnation

This is often one of the most heavily negotiated provisions of a ground lease. Tenant has no interest in the fee estate, but otherwise owns the improvements and has the right to remain in possession for the balance of the term. The leasehold mortgagee is interested in being repaid if the condemnation affects tenant's ability to operate. The fee mortgagee only has the rights to encumber landlord's limited estate, so the considerations of the tenant and the leasehold mortgagee become extremely important. I've had many ground lease negotiations where this clause went through ten or more drafts related to this issue, and it is rare when this does not become a point of contention.

Assignment/Subletting

This is another lease issue that is quite different than what you might expect in a space lease. Because the tenant is generally a single-purpose entity, there is often no (or a limited) net worth requirement for an assignee. Of course, the tenant has either constructed the improvements or purchased them from the landlord, so it is pretty unlikely that the tenant will be assigning its interest to a party that has no credit (and is likely to have similar or better credit than the tenant itself given that it is also purchasing the improvements). One caveat is that an assignment should not be permitted before the tenant constructs the improvements if that is one of its obligations under the ground lease (and in that instance, a guarantee should be obtained). A different issue is the issue of subletting. In many instances, there are leases/subleases in place for all or part of the building or vacant space that needs to be filled up and the tenant would want the flexibility of being able to enter into subleases. Moreover, the tenant will want landlord to agree to provide recognition/non-disturbance protections to major subtenants.

Leasehold Mortgages

The leasehold mortgage section of a ground lease is one of the most complex provisions of it. There are a number of protections a leasehold mortgagee needs and that both the rating agencies and markets require. If the condemnation provision of the lease is one of the most hotly contested provisions of it, the leasehold mortgage section is close behind it (and often is even more heavily negotiated). Please note, that there can be multiple leasehold mortgages, as well as mezzanine financing, applicable to a significant ground leased property, so the parameters of what mortgages would be permitted (e.g. only permitting institutional mortgages) and how multiple mortgages would be coordinated has to be agreed upon. Beyond that, let's turn to the basics of the leasehold mortgage clause. The first principle is that the leasehold mortgagee should receive notice and have the ability to cure any default by the tenant, as well as additional time (but not the obligation) to do so. Additionally, should a nonmonetary default be of the nature that it can only be cured after foreclosure by the leasehold mortgagee, a leasehold mortgagee it will require time to do so (although landlords try to limit that to a reasonable time-e.g. 180 days). However, the leasehold mortgagee should be obligated to cure any monetary default and pay ongoing rent while the foreclosure is being prosecuted, as a condition for landlord to wait for the foreclosure to be completed. Additionally, because there are defaults of a tenant that a leasehold mortgagee could not cure, such as the filing of a bankruptcy by the tenant or an issue with its corporate existence (these are commonly called non-curable defaults), the leasehold mortgagee should not be required to cure such defaults. Beyond all of that, if the lease is terminated due to the actions of the tenant or its bankruptcy, a leasehold mortgagee will require landlord to agree to provide the leasehold mortgagee with the opportunity to enter into a new lease for and upon the remaining terms of the existing lease. All of these protections are necessary to protect the interests of the leasehold mortgagee and although the general principles of a leasehold mortgage section in a ground lease are commonly agreed upon and understood, this provision is extensively negotiated.

Fee Mortgages

As set forth above a fee mortgage must be subordinate to the ground lease. Additionally, because the ground tenant owns the improvements (which it purchased or constructed), a fee mortgagee must not have rights in casualty proceeds or condemnation awards that conflict with landlord's rights in the ground lease. Accordingly, a recognition and attornment agreement from a fee mortgagee is quite different than the subordination, non-disturbance, and attornment agreements ("SNDAs") that most of us have negotiated when financing a fee-owned property. Please note that while modified SNDAs used to be permitted in ground leases, in 2016 Moody's opined that because an SNDA is an executory contract and could be rejected in a bankruptcy by a fee mortgagee, any fee mortgage must expressly (in a ground lease) be subordinate to the ground lease and that any fee mortgage should be recorded after a memorandum of the ground lease was recorded (and generally after a leasehold mortgage is recorded). All other rating agencies have followed suit, so unless the ground tenant is unsophisticated, this express subordination will be a part of a ground lease (and even if not, a future leasehold mortgagee will likely require it, so it makes sense to include this subordination at the outset).

Default

In similar fashion to the protections a leasehold mortgagee will expect, the tenant wants to make sure that its interest is protected in the ground lease and that there is sufficient time to cure any monetary or nonmonetary default if one is claim by the landlord.

Because of this, the time periods, thresholds, and triggers for terminating a ground lease are often more tenant favorable than in a more traditional lease. Of course, this also protects a leasehold mortgagee, in addition to the provisions of the leasehold mortgage clause.

Accounting

Because the tenant owns the improvements, is entitled to take any depreciation on such improvements. At the end of the term, the improvements will revert to the landlord but during the ter,m the improvements are owned by the tenant on an absolute basis (which is recognized by the IRS).

Surrender/End of Term

Although the horizon for the end of the term is in the far distance, on the effective date of a ground lease, the condition of the premises at the end of the term is important to a landlord. In order to make sure that the premises are maintained at an agreed-upon standard and returned in that standard, is not uncommon for a ground lease to provide a deposit to be made during the last five or 10 years to ensure that the tenant returns the improvements in the required condition. Beyond that, the question is often raised about a requirement to provide a reverter deed to landlord if required to confirm the return of the improvements to it. In some jurisdictions that may trigger a transfer tax so many practitioners rely on the language of the lease with respect to the reversion or have a quitclaim (unrecorded) deed or bill of sale serve in lieu of a reverter deed.

Rights of First Offer/Refusal

Because tenant owns the improvements and has control over the property for a period of up to 99 years, it is not uncommon for tenant to ask for a right of first offer or refusal to purchase landlord’s interest in the premises if landlord desires to sell it. If a Landlord agrees to this, it will impose a number of limitations on it and set up a mechanism that would govern any such sale (including limitations on it, payment of transfer taxes, etc.). Conversely, if tenant asks for a right of first offer or a right of first refusal, landlords often ask for reciprocal rights if the tenant wants to convey its interest in the improvements and its estate. These provisions often are quite detailed and heavily negotiated.

Rating Agency Guidelines

All of these have already been explained in the context of the market for ground leases, but it is important to reflect these guidelines to maximize the sale price of the improvements because the buyers of improvements related to a ground lease site are often very sophisticated investors who will be financing their purchases and refinancing them over time.

Conclusion

This presentation provides the basic elements of negotiation of a ground lease. As you have undoubtedly ascertained, the terms and language in ground leases are very precise and nuanced, and one short presentation cannot make anyone an expert in this field. However, many of you will encounter ground leases in your practices and now have a better understanding of the reasoning behind provisions that are intentionally different than their space lease counterparts.

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