PUBLICATION

Adding Value Before Breaking Ground: Keys to a Financeable Ground Lease

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Summary: *A ground lease offers an attractive structure for the development of commercial real estate, allowing a land owner to retain title to the property. However, the lease must contain certain minimal provisions in order to be financeable.*

During recent years, the financeable ground lease has become one of the most popular vehicles for retail development. Rather than purchasing land required for a development, a commercial developer or retail business may elect to lease the land and construct its improvements on leased property rather than owned property. The reasons for the choice of this structure are varied, including the tenant's desire for flexibility and planning, or the landlord's desire to realize a long-term stream of income from his property, without investing the time and capital needed to construct improvements.

Regardless of the reason, the successful development of a retail property under a ground lease structure will depend directly upon the financeability of the ground lease. In general terms, a financeable ground lease is a lease that contains provisions that protect the tenant's lender in anticipation that the tenant will mortgage the lease as collateral for a loan. For a large percentage of tenants, a ground lease development will only be feasible if the tenant can obtain favorable lease financing.

Commercial lenders are willing to lend funds only if the collateral for the loan provides adequate security from which the lender can be repaid in the event of a default. In this regard, ground leases present unique challenges to lenders. The competing interests of the landlord, the tenant, and by extension the tenant's lender, must be carefully balanced if a ground lease is to be the primary collateral for a successful commercial development. Unlike a pledge of the fee, a ground lease mortgage offers to the lender only limited rights in the property. Those rights are by definition limited to the rights granted to the tenant in the lease.

There are eleven key provisions of a typical financeable ground lease, each of which must be carefully negotiated and drafted in order for the lease to be utilized successfully as collateral for a tenant's development loan. By undertaking the lease negotiations with a view toward the subsequent financing, a tenant can eliminate the need to later renegotiate the lease to satisfy a lender's requirements.

Right to Mortgage, Assign or Sublease

The most basic feature of a financeable ground lease is the right of the tenant to mortgage the leasehold, or assign or sublease the premises. Beyond the obvious requirement that the tenant have the right to enter into a mortgage, these provisions are equally important to a lender in evaluating the worth of the security. A leasehold interest that may be freely assigned or sublet by a lender after foreclosure is the most desirable, since it provides the lender with a variety of possible avenues for realizing value from its security. Conversely, a leasehold interest that cannot be alienated without the landlord's consent is of very little value to a prospective lender.

Term

A second basic concern of a lender when underwriting a leasehold mortgage is whether the duration of the leasehold estate will be sufficient to protect the lender. Not only must the lease term extend through the loan repayment period, but also the term should be sufficiently long to afford the lender time to recover the loan balance in the event of a default prior to maturity. If a default occurs, sufficient time must remain on the term of the lease to enable the lender to assign or sublease the leasehold interest or continue the operations of the tenant. In either case, the remaining term should be sufficient for the cash flow from the business to repay the loan balance. A financeable ground lease will often contain a term of 50 to 99 years. At a minimum, lenders will usually require that the term of the lease extend at least 10 years beyond the final maturity date of the loan.

Mortgage Priority

In order for a ground lease to be financeable, a lender will require that its mortgage be superior to any mortgages encumbering the fee title to the property. In other words, if the landlord defaults on a mortgage of the fee, the landlord's lender must not have the right to cancel the ground lease or disturb the tenant (or any successor to the tenant) in its possession of the property. For this reason, a financeable ground lease will typically contain provisions prohibiting the landlord from granting any mortgage against the fee that would prime the ground lease or the rights of the leasehold mortgagee. The lease should also require the landlord to obtain a subordination agreement from any existing fee mortgage holder if the tenant later enters into a leasehold mortgage.

As an alternative to subordination, a landlord's lender will often suggest the execution of a nondisturbance agreement in favor of the tenant and its mortgagee, under which the landlord's lender agrees not to disturb the tenant or the tenant's successor in the event of a default by the landlord. However, most leasehold mortgagees are unwilling to rely on nondisturbance agreements for various reasons, including potential conflicts over insurance and condemnation proceeds, as well as uncertainty as to the enforceability of the nondisturbance agreement should the fee mortgagee's rights in the mortgage become the asset of a bankruptcy estate. Therefore, in most situations, a leasehold mortgagee will require the ground lease to provide for an absolute subordination by any mortgagees of the landlord's fee title.

Default and Rights to Cure

Another key element of a financeable ground lease is the leasehold mortgagee's ability to take the steps necessary to keep the ground lease in full force and effect in the event of a default by the tenant. Since the leasehold mortgagee's collateral will disappear entirely if the ground lease is cancelled, adequate notice and cure provisions are critical to a leasehold mortgagee.

The notice provisions of the ground lease should require that the landlord simultaneously provide to the leasehold mortgagee copies of any notice given to the tenant, and, further, that no notice by the landlord to the tenant will be considered effective if not simultaneously given to the leasehold mortgagee. Similarly, the tenant should likewise be required to provide to the leasehold mortgagee a copy of any notice sent to the landlord.

A financeable ground lease will not only grant to the tenant reasonable rights to cure a default, but also will grant to the tenant's mortgagee sequential cure rights. In other words, if the tenant fails to cure a default, the leasehold mortgagee should receive a second notice of default and have another defined period of time to cure. Tenants and their lenders are usually given a fixed number of days to cure rent and other monetary defaults. Non-monetary defaults, on the other hand, are usually granted a longer cure period and are frequently given an unlimited period of time, so long as the tenant or the leasehold mortgagee is diligently working to cure the default.

The ground lease should provide that the bankruptcy of the tenant will never constitute grounds for termination of the lease, as long as all rent and other payments due under the lease continue to be paid, after a reasonable cure period.

Leasehold mortgagees will often insist on an additional lease provision requiring the landlord to enter into a new lease with the leasehold mortgagee, if the original lease is terminated by reason of a tenant default. This new lease is commonly referred to as a "pick up" lease. Landlords will often resist such a requirement on the grounds that this protection should be unnecessary if the mortgagee has diligently pursued its cure rights. However, this provision will typically require the leasehold mortgagee to remedy past defaults (including payment of rent) as a condition of receiving the new lease. Therefore, the landlord will arguably be made whole upon entering into the new lease and will often receive a more creditworthy tenant by virtue of this change. A leasehold mortgagee will ask that pick up lease rights become effective not only if the tenant defaults, but also if the tenant declares bankruptcy and the ground lease is rejected by the bankruptcy trustee.

Leasehold Mortgagee's Rights of Consent

If the leasehold mortgage secures a construction loan, the mortgagee will expect to have the right to review and approve the tenant's plans and specifications, as well as change orders and modifications to the plans. These rights of consent will often be parallel to the landlord's rights, and in most cases the interests of the landlord and the leasehold mortgagee will be substantially aligned in this respect.

The leasehold mortgagee will also insist that its consent be obtained prior to any voluntary termination of the lease by landlord and tenant, as well as any non-renewal of the lease by the tenant at the end of any term.

Application of Insurance Proceeds

The terms of the ground lease should require the leasehold mortgagee to be added as an additional insured on any casualty insurance policy insuring the improvements on the leased premises, and each such policy should require the proceeds to be payable to the leasehold mortgagee. The disposition of proceeds is generally a matter of negotiation and is dependent largely on the respective interests of the landlord and tenant in the improvements at the end of the lease term. The leasehold mortgagee's objective will be to insure that the premises will be satisfactorily rebuilt or repaired following a casualty, so that the full value of the collateral will be preserved.

The ground lease should also provide that neither the landlord nor the tenant should have the right to terminate the ground lease in the event of a casualty, except with the consent of the leasehold mortgagee, and the lease should grant the leasehold mortgagee the right to participate in the adjustment of losses and settlement due to a casualty.

Use Provision

A financeable ground lease will contain a broad use provision such as one granting authority to use the property for "any lawful purpose." A use provision that limits the types of activities that may be conducted on the premises likewise limits the range of possible avenues available to a leasehold mortgagee to recover value from its collateral. Therefore, a narrow use restriction will severely impact the financeablility of a ground lease.

Recording of Ground Lease

Recording the ground lease or a memorandum of the lease in the land records of the county in which the property is located provides constructive notice to third parties. The legal effect of this constructive notice is to subordinate the rights of third parties to the rights of the parties to the lease. From the perspective of a leasehold mortgagee, this constructive notice is crucial to the protection of its collateral. By causing the ground lease, as well as the leasehold deed of trust, to be recorded, the leasehold mortgagee insures that any future liens, leases, mortgages or other transactions involving the real property will be subordinate to its mortgage and will not impair the value of the collateral.

A memorandum of ground lease need not include every provision of the ground lease, but it should include notations of the term, rights to extend the term, the leasehold mortgagee's rights to receive notice and cure defaults, and the leasehold mortgagee's right to consent to any amendments or terminations of the lease.

Ownership of Improvements
A ground lease should always specifically address whether improvements constructed by the tenant on the premises will belong to the landlord upon expiration of the term, or whether these improvements will remain the property of tenant to be removed when he vacates the premises. Among the benefits to the tenants of ownership of the improvements is the right to depreciate the cost of the improvements over their useful life. The leasehold mortgagee will generally prefer that the ground lease provide for tenant ownership of the improvements, as well as all equipment and fixtures installed by the tenant on the premises.

End-of-Term Obligations
Closely related to the ownership of improvements are lease provisions outlining the tenant's obligations upon expiration of the term. The lease will typically require the tenant to maintain the improvements in good condition and repair, reasonable wear and tear excepted. However, the tenant's maintenance obligations at the end of the term will depend, in part, on who will own the improvements after the lease expires. The leasehold mortgagee's concern will be to avoid any burdensome end-of-term obligations imposed on the tenant. For instance, a ground lease that permits, but does not require, the tenant to demolish the improvements at the end of the term will be more favorably received by a lender than a lease which imposes on the tenant the obligations of removing a building or restoring it to its prior condition. As with most other provisions, the leasehold mortgagee is seeking the fewest number of burdens and the most flexibility in the event it is required to step into the shoes of the tenant following a default.

Estoppel Certificates
Finally, a financeable ground lease will require the landowner to provide to a leasehold mortgagee, upon request, a certificate certifying all matters relevant to the status of the lease, such as whether rent payments are current, whether and when the lease term commenced, and whether any default by the tenant has occurred during the term of the lease.

Developing commercial property through the use of a financed ground lease has become an important part of the real estate development industry across the country. The landowner, the tenant and the leasehold mortgagee each have different perspectives and interests to be protected in this development model. However, a properly drafted ground lease will include provisions balancing all of the various interests. When carefully structured, a financeable ground lease will protect the interests of all three parties and, at the same time, facilitate projects that might not otherwise be feasible.