A Ground Lease Primer: "Dealing" with the Intimidating Ground Lease

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Nearly all real estate developers would agree that ground leases are among the most intimidating transaction documents that they face in pursing land acquisition and development deals for their portfolios. This is true, in part, because ground leases are relatively complicated documents, presenting a myriad of issues for developers and their lenders that are usually avoided by the acquisition of fee simple title rather than a leasehold estate in real property.

It is also due to the fact that most developers are simply unaccustomed to dealing with the challenges presented by ground leases since they tend to be used much less frequently than other traditional transaction documents, such as purchase and sale agreements. Consequently, one key to unraveling the enigmas of a ground lease is to become readily familiar with the issues typically found in these agreements, toward the goal of developing as much ease with negotiating a ground lease as one would typically have in negotiating a land acquisition contract.

Simply stated, a ground lease is a long-term lease of unimproved land. During the term of the lease, in exchange for its rental payments to the lessor, the lessee obtains the right to construct and operate improvements on the property and ownership of those improvements rests with the lessee. Title to the land generally remains vested in the lessor throughout the term of the lease. If the lessee defaults under the lease, the lessor can usually terminate the lease and also become the owner of the improvements, free and clear of the lessee's financing liens.

This risk of loss of the improvements goes to the heart of why ground lease transactions are so complex and why consideration of issues relating to the ability to finance the ground lease from a lender's perspective is so essential. The developer's ultimate goal should be ground lease terms that give the developer and its lender substantially similar rights and protections to those the developer and lender would have achieved had the developer owned the land outright.

A term sheet that addresses the essential business and legal terms of a ground lease transaction can serve as a "primer" for a developer and should include, at a minimum, the following points.

RENT

Rent under a ground lease is usually structured on a net basis, where the developer is required to pay base rent and, as additional rent, all expenses of carrying the land and owning and operating the improvements, including real estate taxes, utilities, and insurance premiums. Base rent under a ground lease is generally established based upon the fair market value of the land and the lessor's expected market rate of return, which is often comparable to permanent loan interest rates.

Developers should evaluate the base rent based on a comparison of the lease versus an outright purchase of the land, using economic projections, including anticipated future capitalization rates and interest rates, as well as the projected economic performance of the project. The complexity of this analysis will depend upon the degree to which the ground rent payable by the lessee is fixed as opposed to variable and is dependent on economic performance or economic indexes.

Since the duration of ground lease terms is usually between 50 and 99 years, it is customary for lessors to require base rent adjustments throughout the lease term, and these escalation provisions should be specifically addressed in the term sheet. Base rent increases can occur on an annual basis, based on a fixed escalation percentage or percentage changes in a specified index, such as the Consumer Price Index. Ground leases can also include "mark to market" rent escalations, where at specified intervals during the lease term, base rent is increased based upon the fair market value of the land in order to give the lessor a rental stream based upon the value of the land over the term of the lease.

These "reappraisal" provisions are troublesome to the developer who requires base rent escalations to be predictable throughout the lease term, not only for budgeting purposes but also to ensure that the developer's leasehold estate can be financed. The developer's lender will be reluctant to finance its leasehold estate where the required monthly rent payments are not ascertainable throughout the term of the loan or may increase at a pace that is faster than the fair market rental value of the site.

Consequently, the developer should attempt to limit the frequency at which base rent is to be reset and insist upon some type of a definitive cap on the possible rent increase or limitation on the land value and the resulting rent escalations it will bear. In addition, the developer should specify the parameters for this valuation procedure. If the ground lease was initially for vacant, unimproved land, then the rent adjustment should reflect only the value of the raw land and not the developer's project. Without this limitation, the rent increase could wipe out the developer's entire investment in the project. The key is to establish a methodology for permitting the lessor to realize some return based on the increased value of its land over time while protecting the lessee from rental increases that impair the economic value of the lease to the developer over time and render the lease nonfinanceable.

To avoid later controversy, the ground lease should include the procedure for determining the land value on a reappraisal date if the parties cannot mutually agree on the fair market value of the land and the corresponding escalated rental payments. The "three-appraiser method," where the lessor and developer each select an appraiser and the two appraisers select a third, is commonly utilized in these types of provisions.

In negotiating the rent provisions of a ground lease, the developer should also specifically establish the date on which rent commencement will occur, which should be tied as closely as possible to the date on which the developer anticipates that its project will begin generating cash flow.

TERM

The term of the ground lease (including renewal options) must be long enough to allow a developer to achieve a return from the project's revenues of all hard and soft project costs incurred by the developer in completing the project plus a market rate of return on such invested capital. This return of and on the developer's invested capital should be consistent with the yields the developer would realize from a project built on land owned outright by the developer. Renewal options should include all economic terms that will be effective during the renewal term and should automatically go into effect without the need for any affirmative action by the developer in order to avoid any unintended termination of the lease. If the economic terms of the renewal period are not spelled out in the ground lease, then the procedure for establishing such terms should be included. In all circumstances, the term of the ground lease should extend well beyond the full amortization of any financing anticipated to be obtained by the developer. A lender will often require the term of the ground lease to extend beyond the stated maturity date of its loan to allow the cash flow from the project as of the loan's maturity date to amortize any unanticipated balance of the financing over the term of the ground lease.

In setting the lease term, a developer should be mindful of the recordation and transfer taxes that may be applicable to the ground lease transaction. The developer should insist that a memorandum of the ground lease be recorded and that the same is senior in priority to any encumbrance on the lessor's fee simple interest in the land and reversionary interest in the improvements. Depending upon the jurisdiction in which the property is located, it is sometimes possible to structure the term of a ground lease and related renewal options to minimize the recordation charges that may be imposed upon the recordation of the memorandum

of ground lease among the land records where the property is located.

FEASIBILITY PERIOD AND CLOSING CONDITIONS

How does a developer's typical feasibility study period and associated rights to freely terminate a purchase agreement interplay with the typical ground lease transaction? One approach is to permit the developer to enter into a binding ground lease that ties up the land but that is later subject to termination by the developer should it determine during the feasibility period that the site is unsuitable. Alternatively, the executed ground lease could be placed in escrow until the developer favorably resolves all feasibility issues. In that situation, the developer should have the right through the escrow arrangement to terminate the ground lease without liability if the developer elects to forego the deal based upon its feasibility findings. Similar concerns arise with respect to the conditions for closing in favor of the developer that are customarily included in purchase agreements, such as those relating to the quality of title to the leasehold estate, environmental concerns, moratoria issues, and issuance of final governmental approval of development entitlements and required building permits. The developer should consider including in the ground lease a right to terminate the ground lease if one or more of these "closing conditions" are not satisfied by a specified outside date.

PERMITTED USE, DEVELOPMENT, AND ALTERATIONS

It is imperative that the ground lease establishes all development rights that the ground lessee may require in order to construct its project on the property. If these rights are not affirmatively stated in the lease, then they may not be available to the developer. In addition, the ground lease should contain a broad "permitted use" clause to ensure the long-term viability of the ground lease for the developer and to make the lease more attractive to a prospective lender or prospective assignee of the developer. The lessor should be required to join in all easements, covenants, conditions, restrictions, permit applications, and dedications that are necessary for the development of the land. The developer should be freely permitted, without the lessor's consent, to develop the land and construct the improvements as well as to make alterations, additions, and replacements as needed to meet changed conditions, as long as the value of property is not diminished and the developer provides assurance that all associated costs will be paid.

LEASEHOLD MORTGAGEE PROVISIONS

It is essential to the developer that the ground lease is suitable for financing on an "unsubordinated" basis. In an "unsubordinated" ground lease, the developer's leasehold estate in the land and improvements serve as collateral for the developer's financing. The lessor's fee simple estate in the land and reversionary interest in the improvements remain unencumbered. Under these circumstances, the developer's lender risks a loss of its collateral, since upon a termination of the ground lease, the leasehold estate and the lender's lien are extinguished and the improvements revert to the lessor on a free and clear basis.

To ensure that an "unsubordinated" ground lease can be financed, the developer must have the express right to mortgage its interest in the leasehold estate (and to collaterally assign to its lender or "leasehold mortgagee" all of the attendant rights of the developer under the ground lease) without the lessor's consent, and the developer's lender must be freely permitted to exercise its foreclosure and other remedies upon a default by the developer under the loan. It is also critical that the lessor confirm that its fee simple estate in the land is unencumbered and not subject to any fee mortgages which, if foreclosed upon, could wipe out the ground lease thereby extinguishing the lender's collateral.

The developer must also incorporate into the ground lease cure rights in favor of its lender to protect the lender against the loss of the collateral. These would include, among others, rights in favor of the lender: (1) to receive notice of the developer's defaults under the ground lease as well as any termination by the lessor of the ground lease; (2) to cure developer defaults under the ground lease within an extended grace period; and (3) upon the termination of the ground lease, to enter into a new ground lease directly with the lessor on the same terms and conditions as the original ground lease upon the lender's cure of all of the developer's prior defaults.

CASUALTY AND CONDEMNATION

In the event the developer's project is damaged by a fire or other casualty, the developer, and not the lessor, should receive the associated insurance proceeds. The lessor will likely insist that the developer be obligated, under these cir-

cumstances, to rebuild the improvements, but this obligation must be made subject to the rights of the developer's lender to be paid the insurance proceeds pursuant to the mortgage instrument securing the lender. In addition, the developer's obligation to rebuild the improvements should be limited to the extent of insurance proceeds actually received by the developer. These provision will be critical to the developer's lender should the lender be required to step into the shoes of the developer in a default scenario. The developer may also want to limit its obligation to rebuild the improvements during the last several years of the term of the ground lease where, instead of being applied to the restoration of the project, the insurance proceeds would be used to pay-off the developer's lenders with any balance being paid to the lessor. In the event of a condemnation affecting the project, the developer should require that the lessor and the developer "equitably" share the associated condemnation proceeds. From the developer's vantage point, these proceeds should be divided so that: first, the lessor receives the value of the land as unimproved and not subject to the burden or benefit of the lease; second, all of the developer's lenders would be paid-off; and third, the developer and the lessor would split the value of leasehold improvements based on their useful life and the remaining lease term. To ensure that the developer's leasehold estate can be financed, the developer's lender must be given the express right to participate in the condemnation proceedings.

EXIT STRATEGIES

As with any project in its portfolio, the developer must anticipate that at some later date the developer may want to sell the improvements that are the subject of the ground lease and include terms in the ground lease that permit the developer to exit from the lease. These "exit strategies" include rights in favor of the developer to assign its leasehold estate and sell the project, to acquire fee simple title to the land, and to terminate the ground lease. It is critical that the ground lease permit the developer to freely assign the leasehold estate and sell the improvements and/or to sublease any buildings constructed on the property without the lessor's consent. Upon a transfer by the developer of its leasehold estate, and provided that the new tenant assumes all lessee obligations under the lease, the developer should be fully released by the lessor. The developer's right to freely assign the leasehold estate and improvements is also essential for the developer's lender who will require the ability to foreclose on the leasehold estate and sell it at a foreclosure sale without the lessor's consent.

A purchase option in favor of the developer to acquire the lessor's fee simple interest in the land (and reversionary interest in the improvements) at certain specified times during the ground lease term also provides the developer with a means to exit from the ground lease. If the lessor will agree to a lessee purchase right, the ground lease should specify the procedures for determining the purchase price (which should be based on the fair market value of the property as improved with the developer's project, and not the "highest and best" use of the property) as well as the other applicable contract terms. Additionally, or alternatively, the developer should consider requiring a right of first refusal to acquire the lessor's fee interest in the property based upon the terms of an acceptable purchase offer received by the lessor from either a related or unaffiliated third party. Another possible exit strategy is a termination option in favor of the developer that includes a "buy-out" or lease termination payment to the lessor. A provision of this type will typically be very deal specific as to the termination fee and the conditions under which it can be exercised.

Despite their complexity, ground leases can be beneficial to both developers and landowners. Since they afford the developer control and development rights over a site without the payment of a purchase price for the land, ground leases eliminate the developer's obligation to "carry" the land on its books before the project has been completed and is generating cash flow. Similarly, ground leases offer the lessor an ability to achieve a steady and predictable income stream through the lessee's rental payments without taking on the risks associated with the new construction of a project.

The key to a successful ground lease transaction is to become conversant with the numerous issues these agreements present so that they may be successfully negotiated to achieve terms for the developer that are substantially similar to outright ownership of the land and that are financeable from the perspective of the developer's lender.