

Ground Leases: Key Negotiated Provisions, Financing Issues, Monetary vs. Non-Monetary Breaches, Additional Rents and the Valuation of Improvements

TUESDAY, JUNE 22, 2021

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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GROUND LEASES: KEY NEGOTIATED PROVISIONS

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OVERVIEW

I. Introduction to Ground Leases

II. Key Provisions

- Rights and Responsibilities of the Parties
- Term
- Due Diligence
- Assignment Rights and Subletting
- Use Provision
- Rent Structure
- Additional Tenant Payments
- Financing
- Ground Lessor Defaults
- Ground Lessee Defaults

III. Long-term Investment Issues

- Capital Events
- Valuation of Property

INTRODUCTION TO GROUND LEASES

- A long-term lease of a vacant piece of land or a previously developed property
- Often called a Land Lease
- The Lessee enters into the Ground Lease to develop, operate and maintain the property for its own account
 - Examples: The Empire State Building, Rockefeller Center, McDonald's, Starbucks, department stores
- Lease term is usually long, triple net, often 99 years
- Separate ownership of the Land from ownership of the Building and improvements constructed on the Land

INTRODUCTION TO GROUND LEASES

- Provides Lessee with advantages and disadvantages of ownership, without having to pay the cost of buying the land
- The Lessee will then, generally, sublet space in the improvement it has built, creating a positive net cash flow allowing for leasehold mortgage financing
- After the Ground Lease expires, all development on the land is turned over to the property owner

RIGHTS AND RESPONSIBILITIES OF PARTIES

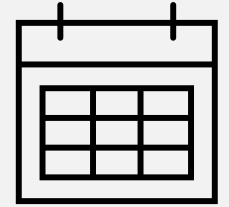
Lessee:

- Construction expenses
- Financing costs
- Improvement costs; Renovation Costs
- Insurance
- Repair expenses
- Taxes
- Duty to Maintain
- Rent

Lessor:

- Revisionary interest to re-enter the property in the event of default or if the Lessee fails to renew
- Title and Quiet Enjoyment
- Provide Lessee with uninterrupted right of use and possession
- Duty to cooperate with construction plan and other Lessee needs
- Termination

LEASE TERM



- Commencement needs to be carefully negotiated as there are frequently conditions precedent, such as financing and zoning, that need to be accomplished before the Ground Lease begins
- Due to the start-up expenses incurred by the Lessee, the Ground Lease usually has a long term, most often not less than 35 years, and often 35-99 years
- If less than 35 years, may not be financeable
- Options to extend the term may be negotiated
- Early Termination
- Once the term expires, the fee interest owner retains the improvements on the land

Ground Lessee Due Diligence

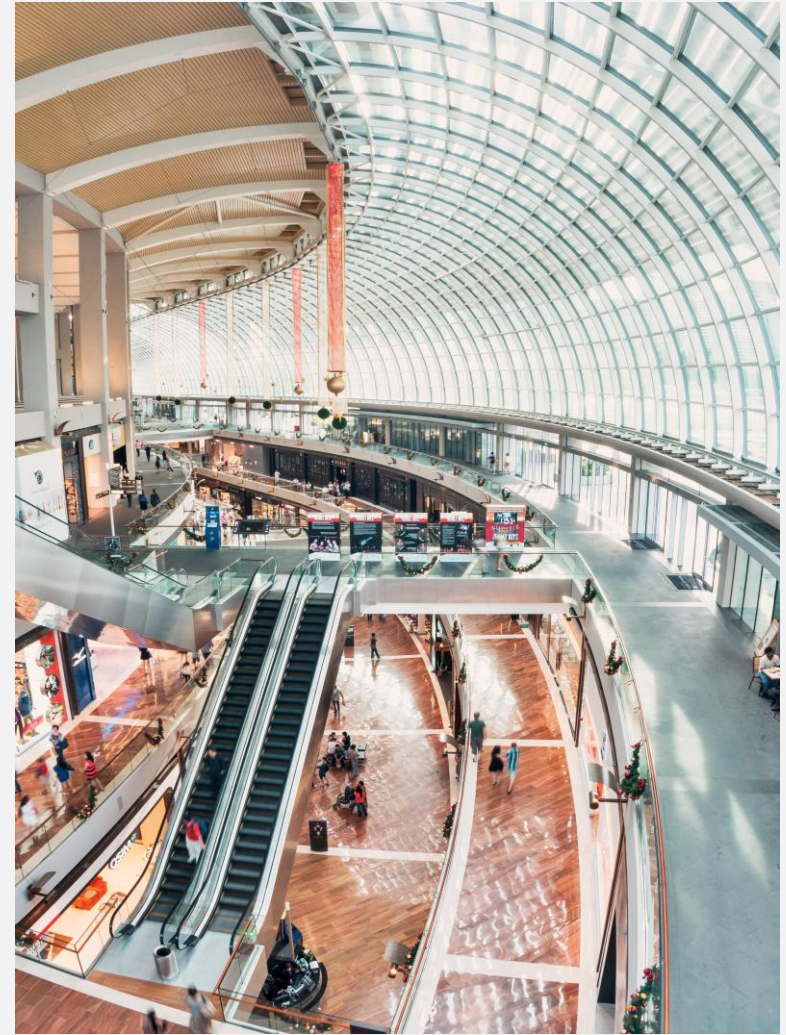
- Because Ground Leases are typically multi-decade obligations under which Ground Lessees have all of the operating control and risk, the property that is being ground leased should be reviewed in the same manner as one would review a property to be acquired, including title, survey, environmental, zoning and related matters
- Ground Lessees should consider purchasing a leasehold title insurance policy to insure against any title defects
- If the ground leased property is part of a larger development, consider whether cross-easements and other rights are necessary to maximize the ground lease property's value within the development
- Consider whether the Ground Lessee will need to be delegated some or all of the Ground Lessor's voting and other rights under a Condominium Declaration or other documents governing the development

Assignment and Subletting Provisions

- Because Ground Lease Terms often exceed 50 years, Ground Lessors should have few consent rights with respect to assignments of the Ground Lease or with respect to subleases
- However, Ground Lessors may insist on typical assignment and sublet prohibitions during the initial construction period to ensure the intended project is completed
- Following initial construction, assignments of the Lease may be subject to a few minimum requirements (including net worth and minimal experience in managing the type of asset in question)
- Similarly, subleases may be required to meet market standards so that Ground Lessor is not forced to take back an asset with below-market leases upon default
- Consider requiring recognition agreements from the Ground Lessor with respect to certain “major” subleases

Use Provision

- Can include: “Permitted Uses”; “Prohibited Uses”; “Indemnity for Violation of Law”
- Lessee’s right to mortgage, sublease, and assign the lease
- Benefits Lessee, but should also benefit lender that may take over lessee’s leasehold



Broad: “any lawful use”

Less Broad: “any lawful retail use”

Restrictive: “for no other purpose”

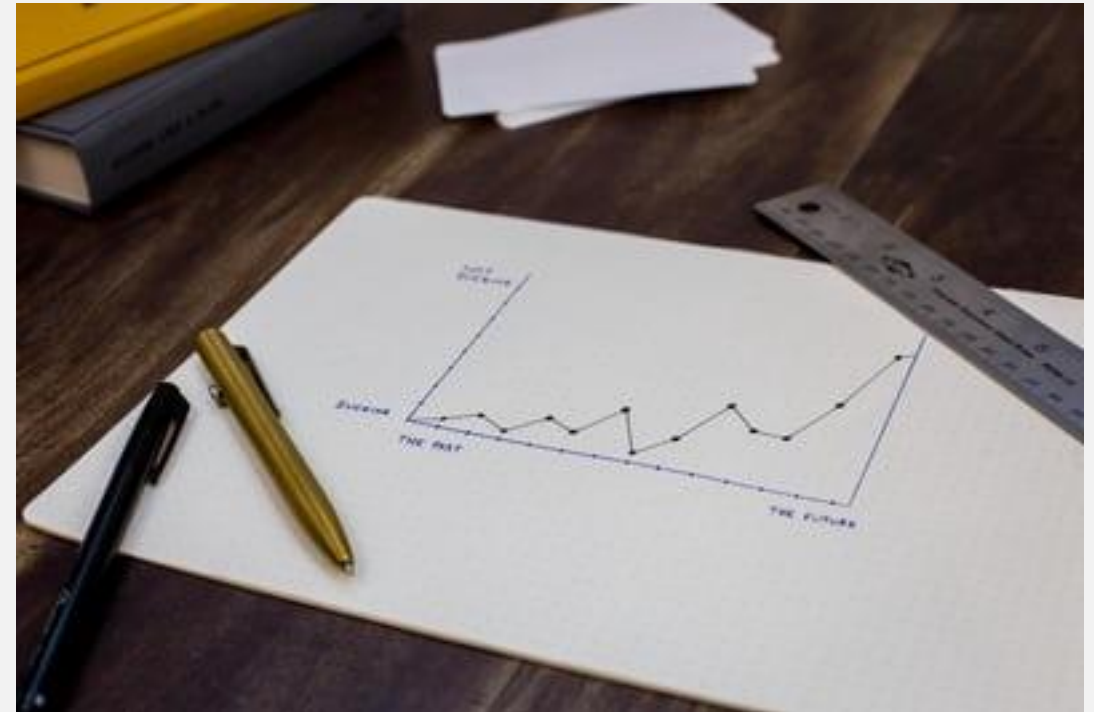
RENT STRUCTURE

Base Rent

- Stated in the lease; paid monthly or periodically

Rent Increases

- Annually
- Periodically
- Other Factors



ADDITIONAL RENT



Can include:

- Annual or step pre-determined dollar amount increase
- Annual or step pre-determined percentage increase (e.g., increase 2% each year)
- Adjust rent periodically to bring in line with inflation
- Adjust rent periodically to bring in line with property appreciation and appraisal
- Appraise for fair rental value using the then-current use of developer's improvements
- Percentage of gross revenue or other measure of financial performance
 - Gross revenue vs. net revenue vs. profit
- Combination of the above (options are endless)

CAPITAL EVENTS

An event, or events, during the ground lease term that is not in the ordinary course of business that creates a positive cash infusion to the Ground Lessee, in which the Ground Lessor may participate



Examples:

- Converting from the construction loan to the permanent loan
- Refinancing
- Sale of the Building



Ground Lease Financing Considerations

- While negotiating the Ground Lease, the Ground Lessee must advocate for the rights of their future construction, mortgage and mezzanine lenders
- Because CMBS and other underwriting standards for financeable Ground Leases evolve over time, the Ground Lease should require the Ground Lessor to agree to reasonable modifications of the leasehold mortgage provisions in the Ground Lease, if requested
- However, basic financeability requirements exist and should be built into the Ground Lease, with a clear right to mortgage the leasehold pursuant to those Leasehold Mortgage provisions

Basic Leasehold Mortgagee Rights

- Lenders should be copied on all Ground Lease default notices (if not also other notices)
- Lenders should have maximum ability to cure Ground Lease defaults to preserve their rights in and to the collateral
- Lenders should be permitted to participate on the Ground Lessee's behalf in any dispute resolution proceeding under the Ground Lease
- If the Ground Lease nevertheless terminates (not as a result of a Lender's failure to cure defaults; e.g., as a result of rejection by the Ground Lessee in bankruptcy), the Lender should be entitled to a new Ground Lease on the same terms for the remainder of the Term
- Material modifications of the Ground Lease should not be made without the Lender's consent
- Ground Lessors should be required to deliver regular estoppel certificates regarding the status of the Ground Lease
- Subtenant rents should not be automatically paid to the Ground Lessor while the Lender is curing defaults and exercising its rights under the Ground Lease (the Lender should have a first lien on these rents while curing)
- Ground Lessor should not be exercising self-help rights while the Lender is curing defaults and exercising its rights under the Ground Lease
- Be sure that future Mezzanine Lenders have similar rights under the Ground Lease

Ground Lessor Protections

- Define the universe of entities who can be Leasehold Mortgagees or Mezzanine Lenders (e.g., institutional lenders who are not Ground Lessee affiliates)
- Lenders must honor those Ground Lease provisions that provide for casualty and condemnation proceeds to be paid to the Ground Lessor
- Lenders cannot foreclose out subtenants unless the subleases are demonstrated to be grossly below market
- While exercising Leasehold Mortgagee cure rights or entering into a new Ground Lease with the Ground Lessor, the Lenders must cure all outstanding defaults (that can be cured; e.g., overdue rent)
- Although Lenders will have additional reasonable periods of time to cure defaults, outside dates for construction completion should be specified in order that a project will not be stalled indefinitely
- If a transfer in lieu of foreclosure is not to the Lender, the transferee should adhere to certain requirements, e.g., minimum net worth and liquidity requirements
- Consider arbitration relating to disputes about reasonableness (with respect to consents, diligent efforts, cure periods, etc.)
- Provide for the ability to be reimbursed for legal fees, as substantial fees can be incurred each time the Ground Lessee refinances its leasehold interest

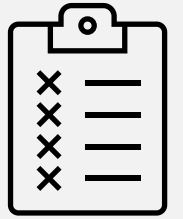
Fee Mortgages

- Following commencement of construction, the Ground Lessee and Leasehold Mortgagees will not want the Ground Lease to be subordinate to any Fee Mortgage
- Because Ground Lessor has few if any obligations, Ground Lessees and Leasehold Mortgagees will require that the Fee Mortgage be subordinated to the Ground Lease or satisfied
- Fee Mortgagee can be entitled to default notices, to cure Ground Lessor defaults and to become the Ground Lessor under the Ground Lease, but its rights can never result in the termination of the Ground Lease (unless there is an uncured default on the part of the Ground Lessee and its Lenders)

Ground Lessor Defaults

- Ground Lessors tend to have few if any obligations under Ground Leases
- However, they often have consent and approval rights in connection with the initial construction and major events
- Be sure to toll construction and other deadlines if the Ground Lessor is slow to respond or a dispute arises
- Consider expedited arbitration provisions to resolve disputes regarding reasonableness
- If Ground Lessor has some significant obligations, provide for self-help and offset rights, as well as the remedy of specific performance
- Consider a cap on Ground Lessor's legal fees when consents, approvals or other cooperation is needed

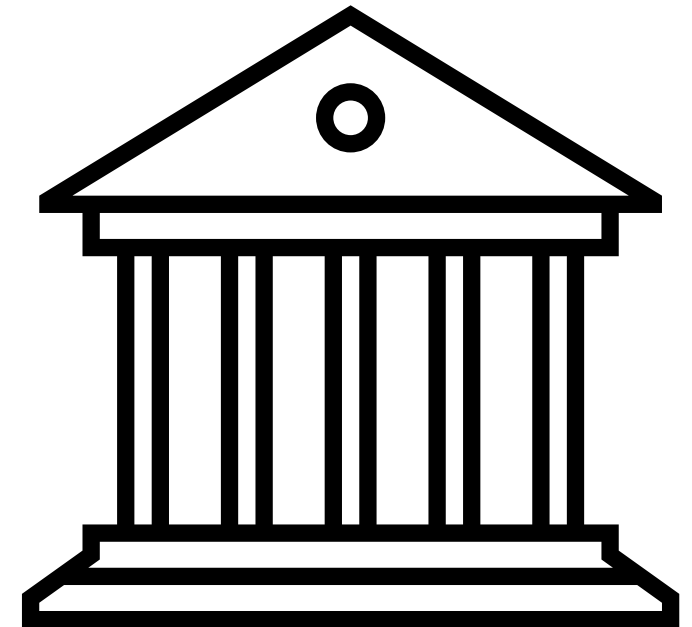
GROUND LESSEE DEFAULTS



- Defaults under a Ground Lease can lead to a lease terminating, depriving the Lessee of a significant investment of equity and debt.
- Lessee needs to structure the leasehold mortgage so the mortgagee can cure the default or take over the lease
- Lessee wants ample notice and cure provisions
- Monetary Defaults:
 - Rent owed to Lessor
 - Additional rent: owed to the Lessor; owed to third parties, e.g.; real estate taxes, insurance, utilities, and contractors
- Non-Monetary Defaults:
 - Those that threaten an immediate problem such as loss of insurance coverage or the imposition of liability on the ground lessor
 - Those that can wait, such as impermissibly deferred maintenance

DEFINING THE EVENT OF DEFAULT

- The stakes are high.
- Lease termination last resort
- Rent: the Ground Lessor's economic motivation
- Additional rent: how bad is the consequence to the Ground Lessor? Longer cure period.
- Remedies: include eviction and Ground Lessor paying for the additional rent or non-monetary default item and suing for the cost
- Redemption: Lessee wants rights to cure even after a judgment for possession is obtained
- Forum: alternative dispute resolution mechanism to be considered, such as mediation



VALUATION OF PROPERTY (FEE AND LEASEHOLD)

Calculate the reversion value of the Land, the present value of the Land, and the imputed value of the leasehold interest

- **Ground Lease Reversion Value:** The value of the Property as if there were no Ground Lease, i.e., a direct cap valuation
 - Net Operating Income divided by the Cap Rate
- **Ground Lease Present Value:** The present value of all Ground Lease payments, plus the reversion value of the Ground Lease at maturity
 - Choice of discount rate
- **Leasehold Valuation:** Take the direct cap value of the Property, before the Ground Lease, and subtract out the present value of the Ground Lease

Questions?



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