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## **GROUND LEASES: BASIC LEGAL ISSUES**

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# GROUND LEASES: BASIC LEGAL ISSUES

## I. INTRODUCTION

### A. Scope

There are a myriad of legal issues involved in any ground lease transaction. This paper focuses on some of the key legal issues in the context of the basic terms of a ground lease. The intent of the paper is not to cover these legal issues in depth, but rather to provide an overview of the issues.

This paper is not intended to give legal advice or to give legal opinions on specific fact situations. The law in each state may vary, so please consult with competent legal counsel for specific advice on the issues covered by this paper.

### B. Ground Leases in General

1. Characteristics of a Ground Lease. While purchase and sale transactions of real property may be more familiar, a significant portion of improved land in the United States is constructed on ground-leased land. Examples include the Empire State Building and the World Trade Center complex in New York.

A ground lease is typically a long-term lease of unimproved land or previously developed property that requires the tenant to construct new improvements. Lease terms typically run 50 to 99 years, and generally no less than 30 years. The tenant typically holds ownership of the improvements during the term of the lease and the tenant has the obligation to pay all expenses attributable to the property except the mortgage on the landlord's fee interest and income taxes owed by the landlord. Because of the significant improvements by the tenant, a mortgage of the leasehold estate is the norm.

2. Reasons for Entering Into a Ground Lease. There are a variety of reasons why the parties may opt for a ground lease transaction rather than a purchase and sale. From the landowner's perspective, the reasons may include one or more of the following:

- The owner retains ownership of the fee interest, which is particularly valuable in circumstances in which land is scarce and values are high or in which the owner is an institution of perpetual duration and may wish to reserve the right at a future point to put the land to another use.
- The owner avoids some of the significant risks inherent in development of real property.
- By leasing rather than selling the land, the owner may avoid replatting or subdivision laws.

A tenant may seek a ground lease for a variety of reasons that may include the following:

- The tenant avoids the large up-front cash payment required to purchase the property, allowing it to use its credit line to improve the property, rather than to acquire the land.
- Improvements are depreciable, whereas the land is a non-depreciable asset. Additionally, ground rent paid by the tenant is deductible as an ordinary business expense.
- The owner is unwilling to sell the land.

There are disadvantages for the owner and tenant, however. Disadvantages to the landowner include the following:

- The long-term lease deprives the owner of the use of the land for an extended period of time.
- Because of the significant improvements to be made by the tenant, the landlord will likely need to permit the tenant more flexibility than an ordinary space tenant would be granted.
- Because of the extended term of the lease, lease rates may not protect the owner over the entire term of the lease.
- Because the tenant is responsible for making substantial improvements, the landlord has a potential risk that the tenant will not complete the improvements and the landlord will be faced with the need to expend funds to complete or demolish the partially completed improvements.
- Finally, because of the likelihood of leasehold financing and the “lender protection” provisions a mortgagee will require, the transaction will likely be more complicated than a sale would have been.

For the tenant, the risks include the following:

- The tenant must make a significant financial commitment over an extended period of time.
- If default occurs under the lease, the tenant risks losing its leasehold estate and the improvements the tenant constructed on the land with none of the protections afforded a mortgagor of land.
- Also, as noted above, the ground lease transaction is often significantly more complicated than a purchase, since it involves not only a complicated ground lease, but also complicated loan documents.

## **II. SUBORDINATED AND UNSUBORDINATED GROUND LEASES**

### **A. The Distinction Between Subordinated and Unsubordinated Ground Leases**

The term “subordinated ground lease” refers to a ground lease in which the landowner has agreed to permit a lien to be placed against the owner’s fee simple interest in the land to secure the payment of the loan made by the construction lender or a subsequent lender to the tenant. The lender has a lien against both the fee simple interest of the landowner and the leasehold estate of the tenant. If there is a default under the loan, the lender may foreclose against both the fee title and the leasehold estate, in which case the owner loses its land.

In an unsubordinated ground lease, no lien is placed against the fee simple title to the land. Instead, the leasehold estate is the primary security for the loan.

### **B. Reasons Why a Landowner Might Agree to Subordination**

It is not typical in current arms length transactions for the owner to subordinate its fee interest, but there may be instances in which an owner is willing to do so. For example, an owner may be willing to subordinate its fee in order to enable the tenant to obtain financing to develop the property, particularly if the financing will permit enhanced development of the property or development of the property in a manner that will enhance the value of the owner’s adjacent or nearby property. Or, the owner may be willing to mortgage its fee interest in exchange for participating in the project’s profits.

### **C. Protecting the Subordinated Fee**

Before agreeing to permit a lien against its fee interest, the owner should consider the following:

1. Evaluate why a lender is unwilling to finance a project without a lien on the fee simple interest. That unwillingness may indicate questions about the project’s viability. The landlord might therefore want to require that the tenant contribute a specified amount of equity or that a certain number of significant subleases be signed as a precondition to subordinating the fee interest.
2. Place a limit on the maximum principal amount, interest rate and term of the loan. That limit might be in total dollars or as a percentage of total construction costs. For added protection for the owner, those limitations should be included in a recorded memorandum of the lease.
3. Require that loan disbursements be made through a third-party escrow agent and that the owner’s consent be given before each disbursement.
4. Make certain that the lease and the deed of trust expressly provide that the loan is non-recourse to the owner. The owner should not sign the promissory

note and should obtain the written agreement of the lender to not seek a money judgment against the landlord.

5. Require additional security from the tenant, such as a performance bond or personal guaranty.
6. Require notice of the tenant's default under the loan documents and the right and adequate time for the owner to cure the default.
7. Limit the subordination to the construction period only. Or, in the alternative, require that the loan be repaid well in advance of the expiration of the ground lease.
8. Allow only one mortgage and prohibit renewals, extensions or modifications of the permitted mortgage.

#### **D. Unsubordinated Ground Leases and Lender Protection Provisions**

If an owner is unwilling to permit a lien on the fee interest, financing will nonetheless be a big issue in the ground lease transaction. Lenders view a lien on the leasehold estate of the tenant as a second lien because, if the lease terminates, the lender loses its security. Consequently, for a ground lease to be financeable, the lease must provide "lender protection" provisions.

Because of the inevitability of financing of the ground lease, a landlord would be well advised to require that, from the outset of negotiations, both the tenant's and the lender's positions be represented. Otherwise, the landlord will find itself first negotiating the lease with the tenant, only to have to subsequently renegotiate many of the significant lease provisions with the lender. By the time the landlord begins to negotiate with the lender, the landlord may have already committed so many resources to the project that it feels pressured to agree to otherwise unacceptable provisions.

The lender protection provisions are not provisions separate and apart from the basic terms and conditions of the ground lease. Rather, they represent modifications to "standard" lease terms that a lender requires for the lender's protection, such that the lender is willing to make a loan secured only by the leasehold estate. The lender's concern is that it may need to foreclose on the project, thus becoming the owner of the leasehold estate and responsible for complying with the terms of the lease.

The scope and nature of the lender protection provisions will depend on the parties' relative bargaining strengths and perceived risks and on the business deal that the landlord and tenant strike. A landlord that receives prepayment at the time the lease is signed of all rentals coming due over the life of the lease has much less at risk and will therefore be willing to provide more favorable lender protection provisions.

Thus, in an unsubordinated ground lease transaction, there are competing interests: the landlord's, the tenant's, and the lender's. The discussion of the basic ground lease terms below will consider issues related to the financeability of a ground lease as they arise with respect to the specific lease terms.

### III. LEASE TERMS

#### A. Construction of Improvements

1. Commencement and Completion of Construction. The construction of improvements by the ground tenant is one of the distinguishing features of a ground lease. The construction period is also the time at which the landlord has the most at risk. Consequently, greater controls on the tenant are justified during the initial construction period and when alterations and additions (as opposed to normal maintenance and repairs) are made.

The landlord needs assurance that the improvements will be built within a set time frame. To that end, the landlord may wish to require in the lease that no construction begin until financing is in place. Depending on the specific facts, it may be appropriate to prohibit construction until a specified percentage of the project is preleased. In phased projects, the landlord may wish to limit the number of sites that may be under development at any one time.

The lease should specify both the date for commencement of construction and the date for completion of construction and should specify that rent will begin on the completion date (even if improvements are not completed). The landlord may also wish to reserve a right of reentry if the construction is not completed in a specified time period. In general, a right of reentry will be enforceable if it does not constitute a forfeiture by the tenant. If the tenant is compensated for the value of improvements it has made to the land, then there will not be a forfeiture.

On the other hand, if the incomplete improvements are in such a state that it would be more advantageous to the landlord to demolish the improvements rather than to complete them, the lease should grant the landlord the authority to demolish the improvements and charge the cost to the tenant. The lease should also prohibit the tenant from demolishing the improvements without the landlord's consent, since the improvements constitute substantial security to the landlord.

2. Construction Standards. The lease should specify the standards for construction. Those standards could be as broad as simply requiring that the improvements be of a first-class nature and consisting of a minimum square footage, or the lease may require the approval of the landlord on all key aspects of construction, including architectural design, budget, and plans and specifications. The extent of the landlord's approval rights will depend on a variety of factors, including whether the landlord is participating in the construction cost or giving a rent credit, whether the landlord has contiguous property, whether the tenant has experience in such projects, whether the construction plans were reasonably complete at the commencement of the lease, and whether the useful life of the improvements is likely to exceed the term of the lease.

The lease should require that the construction be undertaken in substantial accordance with the plans and specifications and in a good and workmanlike manner. The tenant should be required to furnish to the landlord a complete set of plans and specifications, and, if appropriate, an as-built survey on completion of construction.

3. Lien-free Construction. It is also important that the lease provide that the improvements are to be constructed in a lien-free manner. The lease should expressly negate the authority of the tenant to serve as the landlord's agent and to bind the fee interest of the landlord. These prohibitions should also be included in a memorandum of lease so that all potential lien claimants are on notice of the tenant's limitations.

4. Ownership of Improvements on Lease Termination or Expiration. The lease should provide that on expiration or earlier termination of the lease, all improvements become the property of the landlord without payment, free and clear of all liens, and in good condition, reasonable wear and tear excepted. There is, however, a risk in providing that all improvements become the property of the landlord on expiration or earlier termination of the lease. Because of the potential for environmental liability, the landlord would be well served to reserve the right in the lease to exclude any of the improvements and to require an environmental audit prior to the expiration of the lease.

Further, the landlord should retain the right in the lease to require the tenant to demolish the improvements and clear the site at the landlord's request. Particularly in the case of lease improvements that are expected to have nominal value at the end of the term, such a provision is desirable. Use caution in drafting the demolition provisions. If the tenant is permitted to demolish the improvements after the lease expires, the tenant's obligations under the lease, including the obligation to indemnify the landlord and to carry insurance, will not apply during the demolition period. The lease should therefore require the tenant to complete the demolition before the lease expires or should specify those provisions that will apply to the demolition period and survive the lease's expiration.

5. Other Landlord Protection Provisions During Construction. Other protections during the construction period that the landlord may wish to place in the lease include the following:

- Require a personal guaranty from the tenant until construction is complete and all lien waivers have been received.
- Prohibit assignment of the leasehold estate during the construction period.
- Require payment or performance bonds in favor of the landlord.

If the landlord retains property adjacent to the leasehold tract, it will also be important to the landlord to minimize interference with the adjoining property. The landlord may therefore require that the tenant:



- Minimize noise and dust.
- Coordinate placement of trailers and materials.
- Coordinate parking areas.
- Coordinate trash removal.
- Coordinate safety plans.

If the landlord has leases on the adjacent property, the landlord should also take care to avoid conflicts between the new ground lease and the existing leases. Those existing leases may have specific provisions dealing with construction, type of improvements, and related matters.

## **B. Duration of Lease**

1. Length of Term. Because of the significant investment of the tenant in making improvements to the land, the duration of a ground lease is typically for a long term. If the term is less than 30 years, the ground lease is probably not financeable because the debt service requirement will be too high to make the project economically feasible. Because the duration of the ground lease is quite lengthy, often 50 to 99 years, the lease terms are critical and must anticipate various contingencies over the full term of the lease.

The lease term will typically extend beyond the maturity date of the loan secured by the leasehold estate. In some states, laws and regulations specify the lease term for certain types of lenders. For example, life insurance companies regulated by the State of Texas may make a loan on a leasehold estate only if the loan term does not exceed 4/5th of the remaining lease term, and only if the remaining lease term extends at least ten years beyond the term of the loan. Tex. Ins. Code Ann. art. 3.39, Part II.A.2.

The parties may wish to negotiate a preliminary lease term for preconstruction matters and construction work. Preconstruction matters may include title investigation, site inspection, and obtaining subleases and governmental approvals. Then, the actual term of the ground lease will commence on the completion of construction or the date that the lease requires construction be completed.

2. Renewal Options. Often the tenant will seek renewal options. A lender will want the right to exercise the renewal options if the tenant fails to do so and the tenant will want the right to exercise the renewal options at any time so that the tenant may exercise a sufficient number of the renewal options at the time of the loan closing to provide for a satisfactory term for the lease in relation to the maturity date of the loan.

A lease with an option to renew rather than an extended initial term may be attractive to a tenant because the tenant has some control over when its rent obligations end. For the landlord, there is the reality that if a tenant's management is not profitable, the lease may end in default, so there is the potential that the lease will not last for the

full term. Whether renewal options, rather than a simple initial long term, will satisfy state law is a question that must be addressed in each jurisdiction.

An alternative to a renewal option is a longer term with the tenant having a right to cancel periodically. The lender will, however, require that the termination right not be exercisable without the lender's consent. The tenant may prefer an early termination right over an option to renew because the tenant may thus avoid conditions that a landlord may seek to impose on renewal options, such as the requirement that there be no defaults by the tenant.

### **C. Rent**

The long duration of a ground lease poses challenges with respect to setting the rental over the length of the term. Typically a ground lease will provide for rental adjustments at periodic intervals. The concern of such rental adjustments to the leasehold lender, however, is the increasing risk that the tenant will have insufficient cash flow to pay the mortgage.

Rental adjustments can be based on a variety of methods, such as indexing to the consumer price index, reappraising the property at periodic intervals, or applying new capitalization rates. In any event, the lender will want limits placed on the maximum escalations. For example, a maximum percentage increase would be specified for increases based on the consumer price index. For adjustments based on reappraisal of the property, the lender and tenant will want to require that the reappraisal be based on the property as currently improved and not the then-highest and best use of the property.

A lender will also seek to obtain a waiver by the landlord of any rent escalations after the lender has foreclosed on the property or taken a deed in lieu of foreclosure and before the lender has transferred the property to a third party. The landlord, however, should require a maximum time limitation on such a deferral.

### **D. Default Provisions**

1. Space Leases and Ground Leases Compared. Default provisions in a ground lease will often vary substantially from those in a typical, short-term commercial lease. These variances arise because of the basic differences between a short-term commercial lease and a long-term ground lease. As noted previously, in a ground lease, the landlord owns the land only and it is the tenant who has made a significant investment in constructing the improvements. In a commercial lease, however, the landlord is usually the party that constructed the improvements. A ground tenant will want to limit the types of events that will give rise to default and termination of the lease to protect the tenant's considerable investment in the improvements.

Moreover, for the lease to be financeable, the tenant must obtain certain rights for the lender on default. Many of the key lender protection provisions that the tenant's lender will seek pertain to the default provisions because of the lender's concern that the lease might be terminated for a default before the loan is repaid.

2. Notice and Cure Periods. Consequently, there are typically extended notice and cure periods for the tenant, with additional cure periods allowed for the lender. The lender will want the lease to require notice to the lender that is separate from that sent to the tenant and to provide that notice to the borrower does not constitute notice to the lender. The landlord, however, will not want to be obligated to give notice to a lender until it has first received written notice of the existence of the lender. The lease should require that the tenant promptly give notice to the landlord when the leasehold mortgage is extinguished.

3. Types of Default. The lender will also want the right to cure the default if the tenant fails to do so, provided that the default is capable of being cured by the lender. Defaults may be broken down into three categories: monetary; non-monetary and capable of being cured by the lender; and non-monetary and not capable of being cured by the lender. With respect to the latter category, the lease should specifically identify such defaults, which may include items such as the tenant's bankruptcy or the tenant's failure to keep books or file tax returns. Ground leases take different approaches with respect to the latter category. A lender may seek to have such items omitted from the list of events that constitute default under the lease. In the alternative, the lender will want a grace period to enable the lender to obtain possession of the leasehold estate.

If the landlord agrees that certain nonmonetary defaults will not cause a termination of the lease, the landlord should include in the ground lease the right for the landlord to cure such nonmonetary defaults and then bill the tenant for the cost of that cure. In that way, the landlord can convert a nonmonetary default into a monetary default if payment is not timely made by the tenant and then proceed to termination of the lease.

4. "Pickup" Lease. The lender will also seek the right to obtain a "pickup" lease. Typically, a lender will be given 30 to 90 days after the lease terminates to enter into a new lease with the landlord on the same terms as the prior lease and for the remaining unexpired term of the prior lease. The right of the lender to enter into such a lease is often conditioned on the lender curing any outstanding defaults that are capable of being cured by the lender.

There are questions about the enforceability of pickup leases that involve arcane rules regarding the vesting of interests in real property. There is also the risk to the lender that the new lease may be subject to intervening mortgages of the fee interest or other intervening encumbrances.

## **E. Assigning, Subletting, and Mortgaging the Leasehold Estate**

1. Consent to Assignment or Sublease. An assignment is a transfer of the tenant's entire interest in the leasehold. A sublease is a transaction in which the tenant grants an interest in the leasehold estate that is less than the tenant's entire interest. A "sublease" that extends for the entire term of the lease is most likely an assignment instead.

The ability of the tenant to assign its leasehold interest and enter into subleases must be addressed in the ground lease. In some states such as Texas, statutory provisions prohibit subleases or assignment unless the lease allows it.

The type of project and the size and nature of the sublease space will be factors that determine how much autonomy the landlord will allow the tenant in subleasing space in the improvements. If the tenant is the end user, the landlord will want approval rights with respect to the subtenant or assignee. Similarly, if it is anticipated that there will be major subtenants or if there is to be an assignee of the entire project, the landlord will want to retain the right to approve the subtenant or assignee.

Lease provisions requiring that the landlord's consent "not be unreasonably withheld" are not very useful, as they merely invite disagreements on what is "reasonable." Ideally, specific standards of minimum net worth and appropriate experience should be specified in the assignment and subletting provisions.

Because construction is a core element of a ground lease, it is not unusual for there to be an outright prohibition on assignment during the construction period. It is that period during which the landlord is at the greatest risk and is most reliant on the abilities of the ground tenant.

Another factor that may need to be considered in drafting provisions for subleases and assignments is whether the landlord is retaining adjacent property and how that property will be affected by the ground leased site. If the landlord has concerns about competing for tenants or other issues related to protecting the landlord's interest in the adjacent property, the assignment and subletting provisions will need to address those concerns.

Finally, a tenant will want to be released from continuing liability once the tenant has assigned its interest in the lease. Having more than one party liable for performance of the leasehold obligations will be appealing to the landlord, but especially if the landlord has significant approval rights over any assignment, the landlord will more likely be willing to release the former tenant from liability accruing after the assignment to, and the assumption of future liability by, the assignee.

2. Form of Sublease. The form of the sublease document may be important to the landlord, particularly where covenants of the ground lease are to be applied to subtenants. It may be appropriate, therefore, to give the landlord approval

rights over the sublease or to specify the form of the sublease or certain provisions in the sublease.

One important provision to the landlord will be the agreement of the subtenant to attorn to the landlord. In an attornment agreement, the subtenant agrees that if the ground lease terminates, the subtenant will recognize the ground lessor as the subtenant's landlord and make rental payments directly to the ground lessor. In exchange, however, the subtenant will want a nondisturbance agreement in which the ground landlord agrees not to terminate the sublease so long as the sublessee is not in default under the provisions of the sublease.

3. Mortgaging the Leasehold Estate. Because financing is such a key element of a ground lease, the ground lease should also address the ability of the ground tenant to mortgage its leasehold estate. The landlord will want to specify that the leasehold mortgagee must be an institutional lender (such as a bank or insurance company) not affiliated with the tenant. The ground lease should define what constitutes an institutional lender. In addition, the landlord will want to set a minimum net asset level for the lender so that the landlord is assured of the financial viability of the lender. The lease should prohibit non-amortizing or balloon payment loans and, depending on the circumstances, the landlord may also wish to set maximum loan amounts.

If the landlord may want to take back the project, rather than permit the leasehold estate to be transferred at foreclosure, the landlord should seek to require that the loan documents give the landlord notice and an opportunity to cure the tenant's default. Any such payments on the loan by the landlord on the tenant's behalf should constitute an immediate monetary obligation of the tenant and result in a default under the lease if the tenant fails to promptly pay the amount due.

Difficulties arise when the ground tenant wishes to obtain financing from more than one lender, as the lenders will want to address priority issues. The landlord will not want to be placed in the position of determining priorities of the various liens on the leasehold estate or giving notices to multiple lenders.

4. Assignments After Foreclosure. The lender will want special provisions permitting assignment by the lender in the event the lender forecloses on the leasehold estate. The lender will not want to be at risk of being unable to transfer the project once the lender has foreclosed. Thus, the lender will seek to include provisions permitting the lender, after foreclosure or the acceptance of a deed in lieu of foreclosure, to freely assign the leasehold estate without the landlord's consent. If the operation of the leasehold improvements is of such a nature that the experience or creditworthiness of the assignee is important, the landlord may nevertheless need to include criteria for an acceptable assignee.

5. Waiver of Ground Rents After Foreclosure. A lender that is unsuccessful in obtaining the landlord's agreement to subordinate its fee interest to the mortgage may seek a waiver by the landlord of ground rents after foreclosure by the

lender. The landlord should carefully consider such a proposal for the obvious reason that it may result in the landlord receiving no rents on the property for some period of time. Under no circumstances should the landlord agree to an unrestricted waiver of rents — the waiver should include certain parameters:

- ♦ The waiver should expire after a certain number of months following the foreclosure or on the sale or assignment of the ground lease to a new lessee after the foreclosure, whichever occurs first.
- ♦ Notwithstanding the waiver, the lender should be required to apply all rents received by the lender from subtenants in the following order: (1) the payment of all taxes, assessments and insurance premiums required under the lease to be paid by the tenant, the payment of all utility charges on a current basis, and the performance of all other of the tenant's obligations for maintaining the premises or maintaining the improvements in good repair; (2) the payment of normal amortization payments under the loan as they become due; (3) the payment of any ground rents that are in arrears and the payment of rents next coming due; and (4) the payment of additional amounts to further reduce the principal amount of the leasehold mortgage.

## **F. Insurance Coverage, Casualty Loss, and Condemnation**

1. Insurance Coverage. Because of the importance of the improvements to the ground lease transaction, the tenant should be required to insure the improvements for full replacement cost. The lease should require periodic reappraisals of the improvements so that insurance coverage may be adjusted accordingly over the long term of the ground lease. The tenant should also be required to carry rental loss or business interruption insurance to pay ground rentals during the period of rebuilding after a casualty loss. The property insurance carried by the tenant should include coverage for the cost of demolition and for changes in building codes, given the long-term nature of the ground lease.

Both the landlord and tenant should be named as insureds as their interests appear, with a third party as the loss payee. The landlord should be entitled to notice of changes or termination of a policy and should receive copies of the actual insurance policies.

2. Casualty Loss. The tenant should have an absolute obligation to rebuild in the event of a casualty loss, except perhaps towards the end of the term. If there is an estimated shortfall in the insurance proceeds, the tenant should be required to pay the difference before any insurance proceeds are disbursed. All proceeds should be disbursed for construction only.

Although the lender might push to receive the insurance proceeds, to do so would provide the lender with a windfall. To allow the proceeds to be used for rebuilding the improvements maintains the status quo. Consequently, the lease and the

loan documents should make clear that the lender agrees that the insurance proceeds will be available for rebuilding and will not be applied to debt reduction.

If the ground lease requires rebuilding within a specified time, the tenant will want to include a *force majeure* clause to allow for contingencies beyond the tenant's control. The same construction controls that are included in the ground lease for initial construction should apply with equal force to any rebuilding of the improvements.

If the casualty loss occurs in the latter years of the lease term, the lease may excuse the tenant from rebuilding the improvements or give the tenant the option to terminate the lease instead of rebuilding. The lender will have one primary concern with respect to the lease terminating as a result of a casualty loss: the lender will want to require that the leasehold estate not be terminated until the loan is paid in full. The landlord, on the other hand, will want the insurance proceeds to be used first to clear the site. How the proceeds are applied will depend on the relative bargaining strengths of the parties, but the lease should specify the order in which the proceeds will be applied and the application of any excess proceeds.

3. Condemnation. The potential for condemnation is greater with a long-term ground lease precisely because of the length of the term and the likelihood of changing conditions over that time period. The ground lease should address the effect of a total taking, in which the entire leased premises is taken, and a partial taking, in which the premises can be reconstructed and used in an economic manner.

As to a total taking, the lease should provide that the lease will terminate. The question then arises as to how to divide the condemnation award. How the award is apportioned in the lease will depend on the relative bargaining strengths of the parties, but if there is a lender involved, the lender will want to make sure that the amount awarded to the tenant will be no less than the principal balance owing on the loan at the time of the total taking.

There are a variety of approaches to apportionment. One approach is to base the apportionment on the value of the respective estates of the landlord and the tenant immediately prior to the condemnation and apply the ratio to the total amount of the award. A second approach is to give to the landlord the value attributable to the land and give to the tenant the remainder, except toward the end of the term, at which time the landlord would be awarded the residual value of the improvements.

In a partial taking, it is typical for the award to be apportioned with the landlord receiving the amount of the award attributable to the value of the land and the tenant receiving the amount of the award attributable to the improvements and any consequential damages, such as those pertaining to the tenant's ongoing rental obligation. If the tenant receives such consequential damages, then there should be no rent abatement. Another approach to apportioning the condemnation proceeds is to award to the tenant the amount equal to the cost of restoration or repair, then to the landlord the present value of the income stream taken, plus the present value of the

landlord's reversionary interest in the land and the improvements, with the tenant receiving the remainder amount.

If the landlord is willing to provide for an abatement of rent to the tenant in the event of a partial taking, then the lease should address how that abatement will be calculated. One approach is on a per-square-foot basis, but that approach may not consider the true value of the use of the remaining property. Thus, another approach is to provide in the lease that the abatement will be on a "just and proportional" basis.

The lease should address disbursement of the condemnation proceeds for rebuilding. The process should be similar to that for the disbursement of insurance proceeds for the rebuilding after a casualty loss. Similarly, the construction requirements and controls should be those that are applicable to initial construction.

## **G. Use Restrictions**

1. Scope of Permitted Use. Because of the extended term of a ground lease, it is common for the use provision in the ground lease to permit "any lawful use." A leasehold lender will certainly prefer that broad use provision because it maximizes the marketability of the ground lease should the lender foreclose on the leasehold interest.

Use and value, however, are interrelated and past uses may affect future zoning, so a landlord should consider including more stringent use controls in the lease. While the use provision should be reasonable and allow for adjustment for changed conditions over the extended term of the lease, there are various restrictions that may be appropriate:

- Prohibiting noxious or nuisance uses.
- Restricting uses that involve hazardous materials or including significant controls on the use of hazardous materials.
- Prohibiting uses that have the effect of diminishing the fee estate, such as mining.
- Restricting uses that require improvements with limited reuse potential.
- Prohibiting rezoning without the landlord's consent.
- Prohibiting uses that would compete with the landlord's adjacent property.

2. Enforcement of Use Clause. The lease should give the landlord the right to enforce the restrictions without terminating the lease. In other words, the landlord should have the right to enjoin prohibited uses or to specifically enforce the use provisions. Use restrictions in the ground lease should also be made specifically applicable to any sublease and should be required to be included in the sublease.



3. Applicability of Use Clause to Lender. A landlord should use caution when signing documents consenting to the tenant's financing. The consent document may include a waiver by the landlord of the use restrictions if the lender succeeds to the tenant's leasehold interest. Indeed, any consent to financing should be carefully reviewed by the landlord and its attorney because it is common for the consent document to contain numerous provisions that contradict the lease.

4. Changes in Use. If the lease permits changes in use, consideration should also be given to whether rent should be adjusted based on the economic value of the changed use. The landlord will want to be protected so that any changed use that diminishes the economic value does not adversely affect the landlord. On the other hand, if a changed use results in increased economic value, the landlord will want to share in that increase.

5. Continuity of Operations Clause. Finally, the landlord should consider whether to include a continuity of operations clause in the lease. Such a clause is particularly important if the landlord has nearby property that benefits from the use to which the ground lease property is put or in situations in which the rental under the ground lease is based on total sales volume. (One point to note with respect to rental based on sales volume, however, is that for an entity that is exempt from income tax, structuring the ground lease to provide for rent based on net profits may result in unrelated business taxable income to the landlord.)

It will be of some concern to a lender if the lease contains a continuous operation clause. The lender will seek to be excused from the obligation for continuous operation if the lender forecloses on the leasehold estate. If the landlord agrees to a waiver of the application of the continuous operation clause after foreclosure, the waiver should include a specific time limit and an earlier expiration date should the lender sell or assign the leasehold after foreclosure.

## **H. Taxes**

1. Lease Should Specify Payment Obligations. The lease should clearly identify whose obligation it is to pay taxes on the land and on the improvements. State law will address how a leasehold estate is to be valued. There are often special laws pertaining to the taxation of leaseholds when the land is owned by a tax-exempt entity.

2. Separate Tax Parcels. If the parties agree that the land is to be taxed to the landlord and the improvements are to be taxed to the tenant, the lease should require the tenant to obtain separate tax parcels so that the tax obligations are clearly separated. The lease should also require the tenant to give to the landlord evidence of payment of taxes and notice of the tenant's intent to pursue a tax protest and should permit the landlord to participate in those tax protests.

## **I. Mortgaging the Fee Interest**

If the land that is subject to the ground lease is subject to a mortgage, the leasehold estate is probably not financeable and may not be insurable from a title insurance perspective unless the lien on the fee interest is subordinate to the ground lease and to the leasehold mortgage. A nondisturbance agreement whereby the lender holding the mortgage on the fee interest agrees not to disturb the possession of the ground tenant should the fee lender foreclose will likely not remedy the situation. Rather, the leasehold lender will insist that the lien on the fee be subordinate to the leasehold estate and the leasehold mortgage. The tenant and leasehold mortgagee may also require that the fee mortgage loan documents grant to the tenant and leasehold mortgagee the right to notice and an opportunity to cure any defaults under the fee loan.

## **J. Amendments and Modifications to Ground Lease**

1. Lender Consent to Amendments. The leasehold mortgagee will want to prohibit amendments to the ground lease without the lender's consent. The landlord, however, should require that it be the tenant's sole responsibility to obtain the lender's consent. The ground lease should also contain a provision for automatic approval of any amendment or modification if the lender fails to issue an objection within a set time period.

2. Lender Modifications to Lease. The lender will also want the right to require amendments to the ground lease. Such a broad right, however, puts the landlord in jeopardy. Consequently, the lease should provide that the lender's right to require an amendment is conditioned on the amendment making no adverse change in any of the substantive rights, duties, or obligations of the landlord and not causing the landlord to be in violation of restrictive covenants, land use controls and other similar matters affecting the fee estate. Further, the ground lease should stipulate that any lender-required amendment must be reasonable. A requirement of reasonableness does not set a definitive parameter, however.

## **K. Recording the Lease or Memorandum of Lease**

1. Recording Memorandum is Preferable. While it is generally not desirable for the complete terms of the lease to be made public through recording the ground lease in the real property records, it is beneficial to the landlord, the tenant, and the lender for some of the basic terms of the ground lease to be stated in a memorandum of lease that is recorded in the real property records because the recorded memorandum constitutes notice to third parties of the rights and obligations stated in the memorandum. A memorandum of lease identifies the parties, the property, the term and any other significant elements of the ground lease.

2. Description of Leased Premises. The description of the leased premises should include any common areas that the tenant has the right to use and any easements or other special access rights that the tenant has. As with all real property

descriptions, a satisfactory, on-the-ground survey should be the basis for the description.

3. Other Rights and Obligations to Include in Memorandum. It is also important that the memorandum of lease expressly state that the tenant has no ability to place liens on the property. The memorandum should also give notice of other restrictions affecting title to the property, such as any option on the part of the tenant to purchase the property or to extend the term of the lease or any right of first refusal in favor of the tenant to purchase the property. If the landlord has agreed not to mortgage its fee interest or to make any mortgage subordinate to the leasehold mortgage, the memorandum of lease should also give notice of that fact.

#### **IV. CONCLUSION**

A ground lease differs in significant ways from a short-term commercial space lease. It represents a complex transaction and, oftentimes, involves three-way negotiations between the landlord, the tenant, and the leasehold lender. The complexity is intensified by the long-term nature of the ground lease and the resulting need to anticipate events often far in the future. Consequently, a ground lease should be carefully drafted with due consideration to the basic issues discussed above. Simply adapting a standard form of commercial space lease will not serve the parties' best interests.