

GROUNDWORK FOR GROUND LEASES

Program Materials For
UNDERSTANDING THE SOPHISTICATED REAL
ESTATE PRACTICE 2005

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GROUNDWORK FOR GROUND LEASES

I. General Observations

- a. Terms are heavily negotiated and voluminously documented by multiple parties with sophisticated counsel
 - i. Landowner
 - ii. Developer
 - iii. Lender taking ground lease as security, looking toward foreclosure
 - iv. Large subtenant
 - v. Purchaser of leasehold with operating project
 - vi. Other stakeholders
 - vii. See Worksheet attached as Appendix A
- b. Because of length of relationship, there is a need for flexibility by Landlord and Tenant
 - i. Parking, redevelopment of neighboring parcels are good examples
 - ii. Recognize need for change, and obligation to “compensate” other party for change
- c. Issues have changed little over the past several decades (centuries?)
 - i. See gray hair
 - ii. See Bibliography attached as Appendix B

II. Nature of Ground Lease Relationship

- a. Term for years with reversion (divvying up the “bundle of rights”)
- b. Alternative to sale
- c. Can include equity sharing provisions, essentially a joint venture vehicle
- d. Tenant ownership /responsibility for improvements and taxes/ insurance/ maintenance (compare to single Tenant net lease)
- e. Personal liability /non-recourse/ carve outs
 - i. Lease guaranty
 - ii. Completion guaranty
 - iii. May affect economics
- f. Subtenants contemplated

III. Advantages, Disadvantages of a Ground Lease

- a. Tenant—possessor, developer of land
 - i. Lower front end costs (but overall costs usually higher)
 - ii. Rent payments qualify as tax deductible expenses
 - iii. Percentage rent, other equity sharing provisions limit upside potential
 - iv. Declining value (present value analysis)
 - v. Liquidity limited through assignment and refinance provisions
- b. Landlord—retains reversionary right to land and improvements

- i. Likely ground lessors
 - 1. Governments, including Bureau of Land Management (Palm Springs), redevelopment agencies (Times Square)
 - 2. Universities, schools and other “surplus” property owners (San Francisco Centre)
 - 3. Large landowners with near-monopoly (Irvine)
 - 4. Families
 - a. Leased fee is relatively easy to manage
 - b. Income stream is easily divisible
 - c. Because reversionary interest has low value (initially), estate taxes are low
- ii. Value of reversion grows dramatically over time
- iii. Secure rental stream is a “bond” alternative, attractive to institutional investors such as insurance companies and pension funds, with inflation protection via rent adjustments
- iv. Percentage rent, other equity sharing provisions permit upside participation
- v. Development controls, especially if fee subordinated

- vi. Avoids recognition of capital gain (but rent is ordinary income)
- vii. Retains financing risk (if fee is subordinated to a mortgage)

IV. Term/Reversionary Interests

- a. Length of term
 - i. Regulatory requirements for Lenders
 - ii. Practical economics (range 35-99 years)
 - iii. Transfer tax, reassessment
- b. Title insurance coverage
- c. Value of reversionary interest in improvements varies depending on use, condition
 - i. Special purpose or dilapidated improvements may be a liability

V. Rent Structures/Determination

- a. Base rent (can be phased-in or accrued over development and lease-up periods)
- b. Percentage rent (equity-sharing mechanism)
- c. Periodic adjustments (fixed or indexed)
 - i. Periods, caps, floors, banking
- d. Appraisal issues
 - i. Defining "Fair Market Value":
 1. Vacant land or land and improvements--Who paid to construct the Improvements?
 2. Changes in zoning?
 3. Encumbered by the Lease?

- a. Term continued
- b. Use limitations
- 4. Highest and Best Use—
“reasonable, permissible,
physically possible, financially
feasible”
- 5. Maximum FAR test
- ii. FMV multiplier to determine new
base rent (fixed percentage or tied to
a market rate or return)
- e. Additional consideration (parking rights,
condos, preferential or “complimentary” hotel
rooms, etc.

VI. Use Limitations

- a. Specific use
- b. Right to change use
- c. Right to demolish and rebuild
- d. Tenant obligations to construct and operate
- e. Landlord right to approve construction, esp. if
fee subordinated
- f. Landlord reserved rights?
 - i. Parking lots
 - ii. Rooftops
 - iii. Signage/Billboards

VII. “Financeable” Ground Leases—foremost Lender concern is risk the ground lease will terminate prematurely

- a. If the Tenant negotiates well for its own
interests, the Lender’s interests should be
protected

- b. Regulatory, rating agency requirements for institutional, securitized loans
- c. Basic elements of financeability
 - i. Deal points
 - 1. Economics
 - 2. Lease term (Lender right to exercise renewal options)
 - 3. Broad use clause
 - ii. Right to mortgage leasehold estate
 - iii. Notices of default
 - iv. Cure rights, extended cure periods
 - v. Right of possession pending foreclosure or for non-curable defaults
 - vi. Right to assign/sublease
 - vii. Control of amendments, modifications, terminations
 - viii. Right to a “New Lease”
 - ix. Loss proceeds allocations reflecting overall allocation of risk
 - x. Estoppel certificates
- d. Subordination of fee should not be necessary if Lease contains basic protections
 - i. In typical structure, the Landlord “joins” in the mortgage and subjects its interest to the lien of the mortgage, without undertaking affirmative obligations of Tenant to Mortgagee

- ii. Vague requirements to subordinate may not be enforceable
- iii. Partial subordination
 - 1. During construction period
 - 2. After completion of construction and lease up
- e. Bankruptcy—Add obligation for Tenant to object to a Debtor/Landlord sale of property free and clear of ground lease through a court-ordered sale to avoid problem of Precision Industries v. Qualitech, 327 F. 3d 537 (7th Cir. 2003).

VIII. Assignment and Subletting

- a. Must be permitted
- b. Landlord rights of first refusal, first offer for assignment
- c. Operational concerns (experience, financial strength of assignee)
- d. Recognition agreements
 - i. Similar to SNDAs.
 - ii. Is subleased space self-contained?
 - iii. Is balance of space suitable for lease (configuration, size, frontage)
 - iv. Limit Landlord obligations to those under ground lease

IX. Tenant Options

- a. Renewals
 - i. Long notice period
 - ii. Not usually limited to named Tenant

- b. Purchase
 - i. Fixed price or formulaic
 - ii. \$1 “price,” if Tenant “reimburses” land costs in deal
- c. Right of first refusal (with premium?)
- d. Right of first offer
- e. Exemptions from options
 - i. Transfer to Landlord affiliate
 - ii. Foreclosure or deed in lieu
 - iii. Transfer of leased land together with larger project or portfolio sale
 - iv. Transfer of partial equity interests are problematic

X. Defaults—because term is longer and Tenant’s investment is greater than in space leasing, default provisions are more favorable to the Tenant’s/Lender’s interests

- a. Long notice provisions—30 days or more
- b. Categorization of defaults to eliminate “brinkmanship” nature of eviction proceedings
 - i. Monetary/Non-monetary
 - ii. Curable/Non-curable
 - iii. Disputed/Undisputed
- c. Redemption rights?

XI. Reconstruction, Condemnation—Should recognize Developer/Tenant’s and Mortgagee’s right to anticipated returns as if event had not occurred

- a. Continuing rent stream is primary goal
- b. Rebuild obligation if
 - i. Remainder of term is long
 - ii. Leased parcel is integrated with Landlord's larger development
 - iii. Percentage rent or other equity participation
- c. Raze building and scrape land if not obligated to rebuild
- d. Pay insurance or condemnation proceeds to Landlord equal to residual interest in improvements (in addition to value of land in condemnation situation)

XII. Insurance—Provisions in a ground lease are complicated by length of term, scope of Tenant responsibility and interests of various lenders

XIII. Security Deposit

- a. Letter of credit issues
- b. Release
 - i. Upon closing of debt financing
 - ii. Upon completion
 - iii. Upon lease-up

Appendix A-Ground Lease Review Worksheet
Appendix B-Bibliography

APPENDIX A**GROUND LEASE REVIEW WORKSHEET**

Section/ Page	Provision	Summary/ Open Issues
	<u>Term/Reversion</u> a. Initial b. Extension Options c. Regulatory, Rating Agency Requirements d. Condition of Improvements upon surrender e. Title	
	<u>Rental</u> a. Base (phase-in?) b. Percentage c. Escalations d. Appraisal Process e. Goodies	
	<u>Use</u> a. Limitations in Lease b. CC&R's c. Lender requirements	
	<u>Financeability</u> a. Subordination of fee b. Right to mortgage c. No senior liens d. Cure e. Notice of default f. Assignment/Subleasing g. Use h. Exercise Tenant's Options	

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Section/ Page	Provision	Summary/ Open Issues
	i. Amendments j. Estoppel certificates k. Loss proceeds allocations	
	<u>Subleasing</u> a. Permitted b. Recognition Agreements	
	<u>Assignment</u> a. Exit strategy b. Security for Loan c. Foreclosure d. Assignee requirements e. Fees f. Landlord options, ROFO, ROFR	
	<u>Appraisal Process</u> a. Definition of “Fair Market Value” b. Selection of Appraisers	
	<u>Tenant Options</u> a. Renewals (rent determination) b. Purchase c. Right of first offer (ROFO) d. Right of first refusal (ROFR) e. Exemptions f. Notice	
	<u>Personal Liability</u> a. Financial Information Requirements b. Guaranty c. Impact on Subordination requirements	

Section/ Page	Provision	Summary/ Open Issues
	d. Lender Exculpation	
	<u>Defaults</u> a. Definitions b. Cure Periods c. Notice Requirements	
	<u>Insurance</u> a. Coverages b. Application of Proceeds c. Lender requirements	
	<u>Condemnation/Damage and Destruction</u> a. Definition b. Proceeds c. Rebuilding obligation	
	<u>Notices</u> a. Procedure b. Lender requirements	
	<u>Security Deposit</u>	
	<u>Development/Construction</u> a. Approval of Plans and Construction	
	<u>Estoppel Certificates</u> a. Landlord b. Tenant c. Lender	

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