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Ground Leases and the Credit Crunch: Fresh Opportunities

Ground leases have become the focus of renewed interest as owners and developers search for ways to structure development transactions in an environment where, increasingly, the parties can neither agree upon value nor locate debt.

In the present market, where real estate values are in flux and buyers and sellers present dramatically different opinions of the worth of real estate assets, ground leases may offer an opportunity for buyers and sellers to sidestep questions of valuation and instead focus on long-term rental value. At the same time, sellers and buyers may realize benefits from a lessor-lessee relationship.

A cash-strapped owner lacking the capital necessary to develop the property can, by executing a ground lease with a sophisticated ground lessee, maximize the value of the property while retaining any benefit derived from the appreciation of the land after the ground lessee builds its improvements. In addition, a ground lease can help property owners reeling from declines in property values get a steady, long-term stream of income from the property to help weather the downturn.

Ground leasing also provides some attractive features to the lessee. Leasing instead of acquiring land typically requires less upfront capital, thereby freeing the

lessee's funds for development. In addition, ground leases can offer tax advantages to lessees. The improvements to the land are depreciable by the ground lessee. Improvements may also provide a tax deduction greater than the interest paid on a commercial mortgage. Depending on the length and structure of the lease and applicable state law, the lessee may also avoid the transfer taxes that would be paid in an acquisition.

This is not to say that a ground lease does not pose its own set of challenges. In most cases, particularly where the ground lessee plans to improve undeveloped land or otherwise make significant improvements to the site, ground lessees will need to finance their leasehold interest and their ownership of such improvements. Financing a ground lease presents challenges for the leasehold mortgagee that are not present in a standard mortgage, as the leasehold mortgagee's principal collateral is not the property but the leasehold itself.

Consideration must also be given to the effect on the leasehold mortgagee and ground lessee interests in the property if the owner intends to mortgage its fee interest. These issues introduce additional complexity in drafting the agreement, as the competing interests of the ground lessor, fee mortgagee, ground lessee, and

contacts

J.J. Broderick

Philadelphia
215.963.5104
jbroderick@morganlewis.com

Eric Stern

Philadelphia
215.963.5178
estern@morganlewis.com

Kevin Delaney

Philadelphia
215.963.5914
kdelaney@morganlewis.com

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leasehold mortgagee must be balanced in the ground lease.

We'll address some of these competing interests, and the key provisions necessary to make a ground lease financeable.

Term

The term of a ground lease is typically far longer than that of a conventional space or building lease and may last 50 years, 75 years, or more. For a ground lease to be financeable, leasehold mortgagees will seek a lease term that is long enough to permit the debt to be fully amortized from the project cash flow well in advance of the end of the term of the ground lease. Leasehold mortgagees typically require a lease period substantially longer than the loan maturity date in order to hedge against the risk that the loan is not fully paid at maturity. This enables the loan to be refinanced prior to the lease expiration.

Determining the term of the lease is perhaps more art than science for the

leasehold mortgagee. Calculating the proper term of the lease will require the leasehold mortgagee to make assumptions regarding projected cash flows, interest rates, rents, and inflation. In addition, if the mortgage is going to be securitized (not a likelihood as of this writing), consideration must be given to rating agency guidelines regarding how long the lease period should extend beyond the loan maturity date.

Defaults

From a leasehold mortgagee's perspective, the single greatest concern is ensuring that the ground lease does not terminate prematurely, thereby wiping out the leasehold mortgagee's principal collateral. Similarly, a long-term ground lessee that has made significant cash outlays to improve the land will want to ensure that there are adequate protections in the ground lease to minimize the likelihood of an early termination and a forfeiture of its investment. Nearly all leases, including ground leases, will give the ground lessor the right to terminate a lease in the instance of the lessee's material default (typically, although not always, after notice and cure rights have expired).

The ground lessee's failure to pay rent or utilities, maintain insurance, or otherwise comply with the ground lease may not be readily discoverable by the leasehold mortgagee, and may not be disclosed by the ground lessee, particularly when the ground lessee is in financial trouble. To shield against the risk of a termination upon a ground lessee default, the leasehold mortgagee will typically require the ground lessor to inform it of each ground lessee default, and require the ground lease to specify that no ground lessee default notice will be effective unless the leasehold mortgagee receives a copy.

It is also important that the leasehold mortgagee be given a period to cure ground lessee defaults after the ground lessee cure period has expired. Having this additional period gives the leasehold mortgagee time to take the steps

necessary to cure, and avoids the necessity (and confusion) of the leasehold mortgagee's commencing to cure before the borrower's opportunity has been exhausted.

However, the leasehold mortgagee's right to cure alone does not adequately protect its

seems comforting to a leasehold mortgagee, it in fact creates issues and uncertainty. Can a lease and a leasehold mortgage executed and recorded after a fee mortgage prime the fee mortgage? Must the fee mortgagee execute the leasehold mortgage in order to subordinate the fee to the leasehold

The leasehold mortgagee's right to cure alone does not adequately protect its collateral.

collateral. Some defaults (such as a ground lessee bankruptcy) may be curable only by the ground lessee while others (including other types of "status" defaults) may not be curable at all. If the ground lessor has the right to terminate the lease, the leasehold mortgagee will insist that the lease require the ground lessor to execute a new lease (a so-called "pickup" lease) with the leasehold mortgagee on the same terms as the original lease. Absent such a provision, if the ground lease terminates for any reason, the leasehold mortgagee's rights to the collateral will be extinguished. Furthermore, it is possible that liens that were subordinate to the leasehold mortgagee's mortgage will obtain priority during the time between termination of the original lease and commencement of the new lease between the ground lessor and the leasehold mortgagee. Thus, the pickup lease provisions should ensure that any liens granted by the ground lessor on its fee interest are subordinate to both the existing ground lease and any pickup lease.

Battle of the Mortgages and Joining In

Introducing the possibility of a fee mortgage complicates and clouds the financeability analysis for the ground lessee. It also creates an issue of priority between the fee and leasehold mortgages. While language to the effect of "the leasehold mortgage shall be superior and prior to any fee mortgage existing now or in the future"

financing? Will the fee mortgagee subordinate its title? What happens when the fee owner defaults under the fee mortgage?

A sure way to enhance the financeability of a ground lease is to prohibit the ground lessor from granting a mortgage or deed of trust encumbering its fee interest. A private owner might balk at this proposition, but public entities are often indifferent. In fact, any ground lessor that views the ground lease structure as the best vehicle to develop its property at the expense of another (i.e., the ground lessee) may agree to forgo the right to mortgage the fee if such agreement is critical to signing up the ground lessee or its leasehold mortgagee.

If forgoing the use of the fee as collateral is itself painful to the ground lessor, it is certainly preferable to subordinating the fee to the lien of the leasehold mortgage. Where the fee is subordinated (curiously, this is called a "subordinated ground lease"), the fee interest of the ground lessor becomes collateral for the leasehold mortgagee. In the event of a foreclosure, the leasehold mortgagee would recover the leasehold, the improvements, and the fee!

To facilitate such an arrangement, the ground lessor "joins in" the leasehold mortgage, adding the fee as additional security for the repayment of the loan by the ground lessee to the leasehold

mortgagee. For obvious reasons, many ground lessors resist the subordination of their fees, but, as noted above, a ground lessor may find that subordinating its fee interest is the only practical means to see its property developed. Many public entity ground lessors may not have the authority to put the fees at risk.

There is no doubt, however, that the subordination of the fee will increase the value of the leasehold collateral and the financeability of the ground lease, and is a means by which the fee owner may cause its site to be developed with another person's capital.

A ground lessor that joins in the execution of the leasehold mortgage should be certain that its obligation in subordinating the fee is limited to its interest in the fee, and attaches no personal liability. As noted, however, the ability to effect the development of a site that might otherwise lie fallow may be sufficient motivation to expose the fee interest to the leasehold mortgagee's lien. In such instance, of course, the fee owner will no doubt require cure rights to stave off foreclosure in the instance of a ground lessee default.

If the ground lessor is not prohibited from mortgaging the fee to its own leasehold mortgagee, the ground lessee and its leasehold mortgagee will insist on the right to cure any default of the ground lessor under its fee mortgage. Otherwise, the leasehold interest of the ground lessee and the lien of the leasehold mortgagee may be extinguished upon the foreclosure of the fee mortgage.

Determining Rent

One often-overlooked area is the effect of the structure of rent provisions on ground lease financeability. Ground lease rent is typically structured as fixed rent with annual rent bumps and/or consumer price index increases, although a one-time payment at the inception of a lease term is not uncommon. Ground lessors sometimes negotiate a percentage rent or other partici-

pation interest if the expectation is that the improvements will be leased and generate income. Rent is usually absolutely net to the ground lessor, meaning that the ground lessee assumes all expenses relating to the property, including all utilities, services, repairs, permits, and compliance with laws, and all restoration in the event of casualty.

From a leasehold mortgagee's perspective, the most desirable rent structure may be the one in which the rent is a fixed or readily determinable amount because many leasehold mortgagees are institutional investors subject to laws regulating the maximum amount they can loan based on a fixed percentage (frequently around 75%) of the fair market value of the property.

Part of determining the fair market value of the property entails calculating the present value of the rental streams that the property is expected to generate. Therefore, leases that require the ground lessee to pay contingent rent, or rent based on indeterminate factors such as a ground lessor participation interest or a CPI calculation, make it difficult for a leasehold mortgagee to calculate the present value of the rental obligation when computing the fair market value. This makes determining whether the loan is in compliance with institutional investor regulations difficult, which in turn adversely affects the overall financeability (and likely the pricing of a loan) for the lease.

Improvements

In most ground leases, the ground lessee will be constructing or redeveloping the improvements at the site. One of the ground lessor's greatest concerns is the risk that the ground lessee will fail to timely commence construction, or worse, commence construction and fail to complete it. Accordingly, the ground lessor will often insist on strict controls during the construction period. Ground lessors will frequently require that the improvements be completed within a set timeframe and be approved by the ground lessor. If the improvements are not timely completed or

fail to meet the ground lessor's approval, the ground lessor will often have the right to reenter the property and complete (or even demolish) the improvements, at the ground lessee's cost.

To provide further assurances that the project will be completed, ground lessors will often require the ground lessee to provide guaranteed minimum investment amounts, post performance bonds, or guaranties or other security, and any latitude allowed regarding the right to assign the leasehold is typically held in abeyance until certain predetermined initial improvements are completed or perhaps until the project achieves stabilization (if the project is income producing).

The required initial improvements are often articulated in the ground lease, though the extent to which a ground lessor requires particular improvements or reserves approval rights will be a function of its relationship to the project going forward. A fee owner that intends merely to "clip coupons" and possibly demolish improvements at the end of the lease may not require specific improvements or reserve approval rights. However, a fee owner that owns and operates adjoining parcels or expects to receive substantial percentage rents or participation payments will likely require extensive approval rights, including architectural controls.

While ground lessees may be loath to cede too much control over the design and construction of the improvements to the ground lessor, a larger concern for the ground lessee (and the leasehold mortgagee) may be the ground lease provisions relating to the use and alteration of the improvements after they are built. Given the large capital investment and long term of most ground leases, ground lessees need more flexibility to alter premises and/or change their use than do most conventional lessees. If the market for the proposed use declines, if the improvements as built prove to be inadequate for the market, or if rents from ground sublessees

are insufficient to cover lease payments and debt service, the ground lessee needs to be able to alter the premises or their use to make them more profitable or perhaps even viable.

Similarly, a leasehold mortgagee needs to be assured that if the ground lessee is unsuccessful in turning a profit at the site and defaults on its lease or loan, then the leasehold mortgagee is not saddled with a property that can neither be operated at a profit in its current condition nor improved or refashioned without obtaining the ground lessor's consent.

Assignment and Subletting

As with the construction and alteration issues discussed above, the type of project and the nature of the use of the site will be factors that determine how much freedom the ground lessee will have in assigning the lease and subletting the premises or portions of it. If the lessee will be the end user of the site or if ground lessor owns property adjacent to the site, the ground lessor will typically impose more restrictive assignment and subletting provisions.

In addition, most ground lessors will not entertain the possibility of assignment of the lease (or release of liability upon assignment) before completion of required initial improvements and/or rent stabilization because the improvements constitute the "value added" to the land for the ground lessor and, until the improvements are completed, the ground lessor is not getting the benefit of the bargain.

From the perspective of the ground lessee and its leasehold mortgagee, the ground lease should contain as few limitations and restrictions on assignment and subletting

as possible. Ideally, the right to assign will be absolute and the right to sublet unfettered, although it is rare that a sophisticated lessor will agree to the ground lessee's having unconditional rights.

From the leasehold mortgagee's perspective, the ground lease must permit leasehold mortgage financing as well as assignment because the leasehold mortgagee may need to sell the property in the event of a foreclosure (most leasehold mortgagees in the finance business are neither intent upon nor competent to operate the ground lessee's business). While the ground lessor has a legitimate interest in the identity of the ground lessee given that the ground lessee must operate the property and pay rent, this interest may become somewhat attenuated once the project's initial improvements are complete and the project's income is stabilized.

The more modest the ongoing fixed rental obligation, the less concerned the lessor will be regarding the wherewithal of the lessee to pay. Where the ground lessee will not be the end user, subletting is the method by which the ground lessee obtains the funds necessary to make lease payments and pay down the debt. In such instances, the ground lessee will require that the ground lease provide the ground lessee with the flexibility to sublet the property with a minimal amount of landlord interference.

Restoration/Repair Issues

Ground lessors typically intend that their ground lessees be responsible for the restoration of the improvements in the event of a casualty, destruction, or need for repair. A ground lessee will typically insist that if restoration is an absolute obligation, all insurance proceeds be available to the

ground lessee for restoration. A ground lessee wants to make certain that the ground lessor's lender will not and may not require insurance proceeds to be applied to reduce the ground lessor's debt.

If the casualty occurs toward the end of the term, the ground lease may excuse the ground lessee from investing in new capital improvements that will not benefit the ground lessee in the long term or permit a termination. However, if a termination is contemplated in the ground lease, the leasehold mortgagee's principal concern will be to ensure that the loan is paid in full before the leasehold estate is terminated. The ground lessor, however, may want the insurance proceeds to be first used to demolish the damaged improvements. How and in what order the proceeds are applied will often be a function of the relative bargaining strengths of the parties.

Conclusion

Ground leases may present attractive and achievable strategies to facilitate property transfers in a debt-deprived market. Cash-hungry owners seeking income in an uncertain market and developers seeking to avoid large initial cash outlays for the next project may find ground leases a useful device. However, given the long-term nature and complexity of the transaction, the parties must carefully analyze and anticipate the basic ground lease issues described here.

Eric Stern is a partner and the firmwide leader of the Real Estate Practice.

J.J. Broderick is a partner in the Real Estate Practice and head of the Corporate Real Estate Practice.

Kevin Delaney is an associate in the Real Estate Practice.

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