

# GROUND LEASES: HOW TO MARRY FUNCTION AND FINANCEABILITY



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## INTRODUCTION

We all know that ground leases, in which the tenant (Tenant or Ground Lessee) leases land for a very long term, present a special kind of challenge. The Tenant controls the improvements on the property during the lease term, but at the end of the term, ownership of the right to use the land and improvements reverts to the owner of the underlying fee interest in the ground (Landlord or Ground Lessor). The length of the term and the flexibility on the use and control of improvements can create a tension between the concept of fee ownership and a leasehold interest. There is a temptation to have the Tenant control all ownership rights, but, at the end of the term, the carriage turns back into a pumpkin and the Landlord and Tenant are left sorting out surrender issues and settling claims.

The Landlord usually seeks to generate income (in somewhat passive fashion), while still retaining the ownership of a parcel of real estate. This allows the Landlord to monetize the value of the land without giving up long-term control. For the Tenant, a ground lease may be the only way to develop an iconic or important parcel of real estate if: (i) the Tenant doesn't have the financial means to actually purchase the land; or (ii) the owner is unwilling to transfer ownership.

Unlike the development of a multitenant shopping center, a Landlord is typically leasing a parcel of land under one ground lease to a single-tenant user (obviously there can be a ground lease under a multitenant development as well, but those ground leases are not the subject of this article). Indeed,

for certain landlord-tenant parties, a single-tenant ground lease may be the better option.

This article will address the distinctive characteristics of, and issues present in, the typical single-tenant ground lease. These are issues that will likely arise, and should be thoroughly considered, when determining whether the relationship will work whether as a Tenant or Landlord.

## LANDLORD ISSUES

With great benefits and limited detriments, a Landlord may be incentivized to stay “single” through use of a ground lease. Before marrying itself to a single-tenant user under a ground lease, however, the Landlord and legal counsel should consider the following issues.

### Due Diligence

Typically, the ground lease will have many contingencies and will afford the Tenant a long period to investigate and confirm its ability to use and develop the premises as anticipated (Due Diligence Period). These conditions are often expressed as a “pre-tender” term or a “due diligence” term and perhaps also a “construction term” distinct from the typical “operating” term of the lease in which the Tenant operates at the premises and pays full rent. This is because under a ground lease many of the development obligations (and thus many of the development risks) are transferred to the Tenant. Some considerations will include soil conditions, hazardous material present upon the parcel, zoning, building code requirements, anticipated cost of construction, and the like.

In addition to conducting pre-construction investigations and obtaining entitlements, the Tenant may also need to meet requirements imposed by the Tenant’s lender, while juggling the satisfaction of multiple involved parties like the local planning board, county, state, and federal regulators, and the local building department. The Landlord will need to exercise patience as this all plays out. In consideration of the contingency period, the Tenant may have to pay non-refundable monies to the Landlord

until the overall contingencies have been satisfied or waived. While the Tenant would rather not incur additional costs, without such an agreement the Landlord may be unwilling to allow a long Due Diligence Period during which other offers are missed. A prudent Landlord will reserve the right to terminate the lease if not met or satisfied.

### Construction Period

A similar issue will arise with respect to rent concessions during the Tenant’s anticipated construction period. If rent commences prior to the completion of construction of improvements, the Tenant will often seek reduced rent during such period with the understanding that Landlord’s return will be generated once the building is operating. The Landlord’s response will hinge upon its economics and expectations. What are the Landlord’s carrying costs? Does the rent under the ground lease justify a longer period without rent or with reduced rent?

### Landlord Termination Rights

While Tenant, alone, may have the right to terminate the lease during the Due Diligence Period, it is quite likely that the entitlement process will afford both parties the opportunity to reconsider the deal. It should be expected that site plan approval will be required, and the approval process will require planning board approval. If neither is received in a reasonable period, both Tenant and Landlord might want the right to terminate.

If the parcel was pre-approved, there will likely be a set of conditions that the municipality has imposed, such as building height, the maximum size of the building, the footprint where the building can be constructed, the parking area, and use. Those restrictions should be acknowledged upfront, and Tenant should have no right to terminate for a known restriction. If the parcel was not pre-approved, the parties should be prepared to engage in full site plan approval (and the ground lease will need to be specific on the process). The parties will need to work in concert to obtain site plan approval and the Landlord may want the right to seek approvals on behalf of the Tenant to ensure its property is not

tied up for a long period of time without a right to “save the deal.”

### **Expectations for Due Diligence and Safe Harbor**

The Tenant should know what entitlements it needs for its project, and if the entitlements come up short of the Tenant’s expectations, the Tenant (and probably the Landlord) will have the right to terminate the lease. However, the Landlord would be well-served if the ground lease contained a floor plan and site plan with specifications and a range of acceptable parameters as a safe harbor. If site plan approval is granted within the set parameters and the approved site plan is not materially different from the site plan attached to the ground lease, then the Tenant does not have the right to terminate the lease. Of course, the Tenant may not be able, or willing, to commit to safe harbor plans at the time of signing. In this case, the Landlord may alternatively seek to refer to an existing project as its “safe harbor,” with language to the effect that if site plan approval is granted as will permit Tenant’s project to be substantially similar to the existing project, then the Tenant shall not have the right to terminate the lease on entitlement grounds.

### **Termination Rights**

Of course, once the due diligence is completed, the parties may desire to terminate the lease. Timing of the Due Diligence Period and entitlement process will vary. In some instances, this can be accomplished in a matter of months; in other jurisdictions, a matter of years. From the Landlord’s perspective, if entitlements are dragging on and there is not a strong likelihood that the deal will progress (and thus produce revenue), the Landlord may wish to terminate the lease and move on to an alternative plan. Presumably, however, there will be some reluctance to move on as the “alternate” deal is likely to be less attractive than the deal the Landlord initially chose to sign. From the Tenant’s perspective, there may be external pressures (e.g., if Tenant is a publicly traded company and not meeting store opening objectives) or internal requirements to pursue other opportunities if entitlements are not achieved within a reasonable period of time.

### **Construction and Opening Covenants**

Finally, the Landlord will likely require that the Tenant perform construction and open for business. These types of requirements must, by their nature, be more flexible in ground leases that contemplate development of an entire shopping center, with minimum occupancy percentages, more flexible deadlines, and permitted changes in design evolution or tenant concept. Obviously, one area of tension is timing. The Landlord wants deadlines to be as short as possible while the Tenant may seek various extensions to those deadlines (e.g., by force majeure). If the Landlord is willing to entertain such an idea, it should omit the concept of “restrictive governmental conditions” in the list of force majeure events. Otherwise, it may find its deadline meaningless. The Landlord may want to impose specific obligations on the Tenant to diligently pursue satisfaction of opening conditions.

The question, as so often, is the remedy: What rights may the Landlord be entitled to if the Tenant fails to meet these deadlines? Or perhaps more importantly: What remedies will actually help the Landlord in this situation? In certain extreme circumstances, the Landlord may seek self-help rights to step in to Tenant’s shoes and satisfy the conditions itself. However, this self-help concept assumes a certain element of bad faith on the part of the Tenant and may otherwise not be of much practical use. In such a situation, the Landlord is likely to find self-help difficult or even impossible as the Tenant may find other ways to avoid moving forward with the deal. The right to step in and complete work will not be meaningful if it results in construction of a building for a defaulting Tenant.

Likewise, the right to recapture may lead to Landlord owning a partially complete building ultimately requiring demolition. Having a letter of credit or other source from which Landlord can collect may be crucial. Landlords would prefer to have as many rights as possible in the event Tenant defaults in its construction or opening obligations, and a special-purpose Tenant without a guarantor or letter of credit may leave Landlord with no remedy. In a standalone ground lease that is not an outparcel to

a shopping center there may be more flexibility, but the Tenant may ask itself: If there are no buildings, how would the tenant pay the rent? This is particularly relevant for a single-purpose Tenant.

### **Financeability**

Financing for ground leases is much more likely to operate on multiple levels than a typical commercial lease. While a standard commercial lease will allow a landlord to mortgage the property, execute a Subordination Non-Disturbance and Attornment Agreement (SNDA), and may grant a tenant the ability to mortgage leasehold improvements, these provisions are generally treated as the tail on the dog. However, in a ground lease context, financing on all levels is a real and significant concern. The Landlord will likely want to encumber its property. The Tenant will need to finance construction of the project. In an outparcel ground lease, there will be adjacent owners and their lenders reviewing the lease and making “helpful” comments, which all parties must address. In addition, the question will arise as to what happens if a party defaults in a developmental ground lease with a municipality?

The best option for the prudent Landlord and Tenant will be to execute a series of interlocking nondisturbance and recognition agreements. These may well be the most complicated portion of the ground leasing process if done thoroughly and properly. For example, if the Tenant defaults under the ground lease and the Landlord is ready to exercise its self-help rights by stepping into the Tenant’s shoes as landlord of Tenant’s tenants, how do you resolve the discrepancy between obligations if a new tenant is now occupying the space? The Landlord would prefer to keep clipping coupons, having no obligation to perform any maintenance, repair, or other duty typically required of a landlord under a standard commercial lease. Tenant’s subtenants, of course, are not going to be willing to continue paying building rent if they do not receive the building services they negotiated for.

### **Tenant Foreclosure**

Another issue is whether the Landlord is willing to allow the Tenant’s lender to step into the lease. The Landlord may be relying on an experienced operator for a specific use (which a lender is unlikely to have experience running) but a balance must be negotiated if Tenant’s lender is requiring the right to foreclose and occupy the property upon Tenant’s default. Landlord’s lender, on the other hand, almost certainly underwrote the loan assuming Landlord’s obligations would be limited to the proverbial “clipping coupons,” but what happens if they are suddenly forced to step into an SNDA between the Landlord and one of the project’s tenants? These issues must be addressed methodically, with the recommendation that practitioners use charts to keep track of how various responsibilities flow. Ideally, financing negotiations will take place with all the players at the same time. What happens if the Tenant is bankrupt? What rights does the lender have if it cannot cure such bankruptcy?

### **1031 Concerns**

Another financing consideration is that single-tenant ground leases have a huge following among Section 1031 buyers that typically look at these deals as an alternative to fixed-income bonds. In this case, instead of “clipping coupons,” they collect and deposit rental checks. The risk of the buyer is easily assessed by reviewing the tenant’s credit rating. The ground lease offers a perfect vehicle for this: the Tenant is responsible for paying real estate taxes directly to the municipality, maintaining, repairing, and insuring the project and improvements, and paying rent under all circumstances. Essentially, in a true ground lease, the Landlord has passed off all responsibility with respect to the project, other improvements, and the real estate itself to the Tenant. If the ground lease is drafted properly, it is an attractive vehicle for a Section 1031 buyer.

The real estate attorney representing the Landlord should view the lease through the lens of a Section 1031 buyer, to ensure that the Landlord has no, or at least very limited, responsibility toward the operation of the property. As an alternative to

bonds, the Section 1031 buyer will focus on lease term and the creditworthiness of the Tenant. A common approach to achieving an adequate lease term is what has been referred to as “extend and blend.” If a creditworthy Tenant is a party to a ground lease that has only 10 years of term left, a Section 1031 buyer may shy away from purchasing the property; but, if the Landlord convinced the Tenant to extend the lease term for another 10 years at an attractive rental rate, the prospective Section 1031 buyer may have an interest in purchasing the property from the Landlord.

### **Tenant’s Use Clause**

In a stereotypical ground lease, the use clause may be as simple as: “The premises may be used for any use permitted by law.” But that is not the case in a shopping center, where the tenant mix is crucial, and thus a single-tenant ground lease may actually need a use clause just as restrictive as those required by a multitenant lease. This creates more risk for the Tenant under a ground lease which may also be undertaking development and approved risks beyond those typically undertaken by inline retail tenants. Permitted uses for the Tenant may be negotiated heavily, and the prudent Tenant will seek rights to change the use over time as there can be no guarantee that the use initially contemplated will be appropriate over such a long term. The Landlord may respond with limited flexibility but may also seek to recapture the premises if the project “goes dark” or if the Tenant seeks to change the use.

### **Exclusive Uses and Enforcement**

The Tenant will need to be sure it will not be faced with unreasonable hurdles in its operations and the ground lease itself will need to permit the Tenant to manage, control, and operate the parcel as if it was the owner, with little constraints imposed by the Landlord. The Landlord may be quite willing to afford the Tenant the control that it requires but may have concerns that an absentee owner does not have. If the Landlord owns an adjacent shopping center, it will not want the ground-leased parcel to compete with or adversely affect that nearby project. The Tenant may also want to control and restrict

other property that the Landlord owns or may own. The Landlord and Tenant will need to address the concerns of the parties to the ground lease itself and perhaps also enter a reciprocal easement-type agreement.

Some Landlords may not have nearby project concerns, but they may be focused on the long-term effects. For example, if the Landlord is a family that has owned the real estate for generations and has no interest in selling the land, may be concerned about what happens in the future when the ground lease term comes to an end. An astute Landlord will want to ensure that its property can be put to the best and most profitable use at the time; perhaps it will be for the permitted use or perhaps it will be something else. The Landlord will also wish to restrict the building heights and signage on the parcel subject to the ground lease in order to respect the restrictions that the remainder of the development will expect from Landlord on the adjacent land.

The prudent Tenant may also seek restrictive covenants to protect its use. These restrictions may well be contained in the ground lease itself or they may be exported to Reciprocal Easement Agreements (REAs), Operation and Easement Agreements (OEs), or other documents. The risks of these agreements to the Landlord are the same as they are to the landlord of a commercial lease—the list of potential covenants grows ever shorter and may continue to reduce or evolve.

Another challenge for Landlords may be dealing with ownership of other outparcels by parties other than the Landlord. When the Landlord agrees to protect the Tenant’s use, it must be sure it can enforce such agreements through OEs, etc.

### **Casualty/Obligation to Rebuild**

In almost all ground leases, the Tenant is obligated to fully insure the building and improvements upon the land for full (or nearly full) replacement costs or value. Tenants may have the choice to rebuild or not in the case of a casualty, but if Tenant elects not to rebuild, it should still raze the structure and remove all debris leaving the site in a clean condition. Unlike

a typical net lease, the Tenant is still obligated to pay all rent to Landlord; the concept of rent abatement is not usually recognized. Tenants may look for the right to terminate the lease in the event a casualty occurs during the last year or two of the lease term. Landlords should be more receptive to this provision if the Tenant is still obligated to pay the rent for the remainder of the ground lease term—particularly as the Landlord may find little advantage in having a tenant-specific building on its land at the end of the term. While this concept may seem unfair to the Tenant, it is not much different to a lender of a commercial loan that does not accept less than the full amount due under its loan for the entire term of the loan.

### **Landlord Recapture Rights**

In the event a casualty renders the premises closed for a period of time, the ground lease may grant the Landlord the right to terminate the lease and recapture the premises. This recapture right is more common where the parcel is located adjacent to a shopping center, for instance, and Landlord is concerned about the business impact of a vacant parcel. This might result in a lease requirement that the Tenant: (i) notify the Landlord of its election to rebuild within a certain period of time after the casualty occurs; (ii) commence to rebuild within a period of time after the casualty; (iii) complete the rebuild within a period of time; or (iv) any combination thereof. Failing receipt of that notice, Landlord can recapture. If the Landlord elects to recapture, the parties will have to attend to a few issues, including an assignment of the insurance proceeds to the Landlord and the Landlord's payment of the unamortized amount of the Tenant's investment in the site (with "investment" to be negotiated inasmuch as some cost will be inclusive and others not).

### **Condition of the Property at Reversion**

The most obvious issue relating to termination of a ground lease is the condition of the improvements. In certain situations, the Landlord may require the return of vacant land and the parties must negotiate to address costs and timing. The Landlord may want

the security to assure this end or term obligation to avoid having to chase the Tenant. More typically, Landlords anticipate receipt of a building in good condition and working order that can easily be re-leased. In those situations, the Landlord may permit the Tenant to remove furniture and trade fixtures but must be cautious to not release any building fixtures or building systems, such as HVAC and plumbing. Requiring a valuable building at reversion will also seek to prohibit the Tenant from making significant alterations to the structure of the building or building systems without the Landlord's consent.

Tenants will strongly object to these restrictions, particularly in a lengthy ground lease where the Tenant may need to redevelop the building over time to keep generating income or where a Tenant may vacate before the end of term. The Tenant may also object to returning the building in good condition if the Tenant believes that the Landlord plans to demolish the building and repurpose the property with new improvements, in which case the demands for repair may simply be a holdup on the Landlord's part seeking to obtain money from Tenant in exchange for waiving these repair obligations.

### **Contamination and Waste**

As a matter of course, the Landlord will also want to make sure that at the end of the term there is no environmental contamination or other waste on the property. The concept is no different than in a commercial lease, but the risks are higher with a ground lease since the Tenant will be undertaking all construction and has, essentially, total control over the property for a longer period of time. These risks may be heightened if the Tenant intends to undertake some sort of industrial use or other activity with a higher risk of environmental contamination. As a result, a prudent Landlord may seek to require some sort of environmental inspection prior to return of the premises and may want to consider a letter of credit or similar credit enhancements to address these risks.

## Renewal Rental Rates

Renewal terms are desired by Tenants in a ground lease for the same reason they are in a standard commercial lease: they give the Tenant the ability to control the property over the long term with a fixed cost (or at least some element of cost control) without the obligation to commit to renting over the long term. The discussion over length and number of renewal terms is not dissimilar to a commercial lease and the desire of the Landlord to get the longest possible notice of election is the same. The crux of the renewal term discussion for ground leases is the renewal rent. Most Landlords will be far less concerned about the length of time that the Tenant may occupy the property if they are confident that they are not losing out on potential value. In a standard commercial lease, fixed rent increases, whether expressed in dollars or percentages, are common. But the long length of the typical ground lease (as well as the goal of many Landlords to simply look for a “coupon clipping” investment) makes the risk of losing anticipated return more threatening. Tenants, of course, want fixed rent. As usual with fixed rent renewals, Tenants benefit both ways: (i) if rent is under market price at the time of renewal, they can renew and take advantage of the low rent; and (ii) if rent is over market price at the time of renewal, they can simply relocate or renegotiate with their landlord while threatening to relocate. The advantage to the Tenant grows when considering the long-term and flexible uses typically associated with a ground lease.

As such, Landlords should obtain protection against the risk of inflation and opportunity costs. Protecting against the risk of inflation can be addressed by simply requiring a Consumer Price Index (CPI) provision. Landlords should be aware, however, that this provision is at best a rough measure of increases in ground lease rents and addresses only one potential driver of future rents. To protect against opportunity costs, the Landlord should require a standard fair market rent provision and a “highest and best use” standard. In a traditional commercial lease, the calculation of fair market rent will often include a reference to the permitted use. However, a Landlord

may find the standard too restrictive. At the end of the initial term (perhaps 40 or 50 years) the highest and best use for a property initially constructed as a shopping center might be very different. The property might generate more income as a residential or office tower or even a specialized industrial use. In such event, the Landlord wants to be compensated for losing out on that opportunity. The highest-and-best-use standard frees Landlords from a restrictive use that undervalues the property but may move rent out of reach for a Tenant seeking to renew. Also, Tenants should be aware that if they rent vacant land and construct improvements at their expense, during any fair market renewal, rent will be increased to reflect the value of those improvements. The Landlord will simply understand this as part and parcel of the bargain, but some Tenants find this a bitter and unexpected pill to swallow.

Renewal rental rates can also be set by arbitration or appraisal. Landlord and Tenant must be careful to specify the parameters for appraisal or arbitration. For example, is the lease itself—and perhaps the existence of other renewal options—to be considered in evaluating the premises? How are the Tenant’s improvements to be considered? As in any arbitration, the question for resolution by the arbitrators should be precisely stated. Although arbitration and appraisal provide some comfort insofar as they are impartial, their goal is usually to set a fair market rental rate within the bounds prescribed by the Landlord and Tenant. The same effect can be reached by prescribing a fair market rental rate for renewal terms.

As one might expect, there is a good deal of litigation about the fair market rent in long term ground leases. There, Landlords make commitments that appear inauspicious 20 or 30 years after the term begins. The Tenants, however, have built costly improvements on the ground and are hardly able to leave. And, whether these costly improvements, as well as other considerations, are included or excluded in an appraisal varies from lease-to-lease and state-by-state.

## TENANT ISSUES

While many of the Tenant's considerations in entering into a long-term single-tenant ground lease are inevitably intertwined with the Landlord's issues described above, since the Tenant is assuming the risk of (in most cases) construction of improvements and the ongoing operations of the leased premises to derive revenue, there are particular concerns facing a Tenant.

### Landlord Work/Approvals of Third Parties

Although traditional long-term ground leases involve the Landlord doing no upfront work other than being a helpful hand and cheerleader during the Due Diligence Period, some Tenants are now requesting more partnership from the Landlord. The first area where a Tenant will ask for some participation from the Landlord is in preliminary site work. Since the Tenant may be a multi-location national operator, it may not be familiar with the topographical nature of certain areas of the country and therefore ask the Landlord for a little bit of risk assumption in the performance of basic site work prior to vertical construction which is to be done to the specification of the Tenant. The cost of this site work may be considered in rent negotiations and/or may require an out-of-pocket contribution from the Tenant, but the Tenant is relying on the Landlord's knowledge of the "dirt" to gain comfort that the site will be made right for development.

Similarly, the Landlord is likely to have a better understanding of the relationships among adjacent property owners, especially in a larger development. Accordingly, prior to spending dollars during the Due Diligence Period, the Tenant may ask the Landlord to obtain any necessary approvals from third parties in order for Tenant to construct its proposed improvements and operate its proposed business. To be clear, these do not include governmental approvals or permits, but rather consent needed under an REA (e.g. architectural review, approval of outparcel tenant, etc.) or from any other private landowner.

If the Landlord does agree to perform work at the leased premises as described above, the Tenant will be certainly focused on both: (i) the Landlord's timeline for completion; and (ii) remedies available to the Tenant to the extent the Landlord fails to complete such work. As far as timelines are concerned, Tenant may bargain for an "outside delivery date" by which time the Landlord is to complete all of its work. This allows the Tenant to know when it will need to mobilize its construction team and provides a rough estimate of when it may be able to open its business. A Tenant and Landlord may agree that delivery is not required during the winter months in those states where weather is an impediment to site work and other work. To the extent that the Landlord does not timely complete any work which it agreed to undertake, the Tenant will likely seek offset rights (sometimes on a day-for-day basis) to base rent for delays in delivery and other offset rights to the extent Tenant is forced to complete Landlord's work. Rarely will you see a termination option for failure of the Landlord to deliver, but the financial penalties can mount up and encourage performance. Recently, Landlords have walked away from completing work due to lack of capital.

### Permitting Contingencies

As discussed above, the permitting process can be arduous for both the Landlord and the Tenant as the parties are basically in a holding pattern, waiting for the local municipality to confirm whether the business terms of the lease can be fully realized. In addition to the considerations listed above, the Tenant will pay particular attention to: (i) what happens if the permitting authority requires significant alterations to the Tenant's intended improvements; and (ii) with respect to restaurant and bar operators, what happens if the Tenant is unable to obtain a liquor license to serve alcohol at the leased premises. With respect to material alterations, a Tenant may bargain for a termination right if the permitting process requires material alterations to Tenant's plans. Many national operators have a prototype building footprint and appearance and if they are not able to open with the same characteristic as their other locations, they may not want



to move forward with the construction and dilute their brand image. Similarly, if serving alcohol is germane to a Tenant's operations, the Tenant may seek a termination right if it is unable to obtain (or if it is economically unfeasible to obtain) a liquor license. In certain states where liquor licenses are limited or sold at auction, this is of particular concern to the Tenant and its budget for the project.

### **Exclusive Uses (Tenant's Take)**

As discussed above, prudent tenants will often seek to prohibit or restrict adjacent properties from operating in direct (or proximate) competition to the operations of the Tenant. In stand-alone parcel deals which are not part of a larger development, the Landlord may not be able to grant any such rights as it may only own the parcel being leased. The Tenant may still ask the Landlord to not lease to a competitor if the Landlord subsequently acquires property within a certain radius of the leased premises.

Tenants may have a list of direct competitors or certain types of operations to be included in their exclusive use clause. The Tenant will seek as broad of an exclusive use clause as the Landlord will allow, but such a clause is basically worthless unless recorded in a document of record (e.g., a Declaration of Covenants or a Memorandum of Lease) in order to put other parties on notice of the granted rights.

Realistically, a Tenant can only seek to enforce the exclusive use clause against the Landlord, but the ability to seek injunctive relief from a third-party bad actor (a "rogue" tenant) is something worth negotiating. Ultimately, the Tenant will want the option to remove itself from the lease entirely in the event of a violation or to stay if there is no effect on profits. Either way, the Tenant is seeking a hammer for the Landlord's decision to intentionally violate a bargained for right.

### **Recapture Rights (Tenant's Take)**

Post-COVID Tenants will likely balk at strict recapture or termination rights for failure to operate. In a recapture or termination situation where the Landlord wants to avoid a "dark tenant," a Tenant will

likely argue that as long as it pays rent, there is no problem. If the cost of operations itself is hurting the bottom line and the Tenant can float the fixed costs of rent, then the Tenant wants maximum flexibility to bide its time until a more advantageous operating environment emerges. Accordingly, a Tenant may ask for the right to be dark for 365 days or more before the Landlord can recapture. Additionally, the Tenant may want the flexibility to completely renovate its business and then reopen to the public with a new strategy following any number of adverse economic events. The Tenant should bargain for as much flexibility as possible with the obligation to pay rent remaining constant.

### **Assignment and Subletting**

In the Tenant's perfect world (since it is the autonomous operator of the premises for a long-term lease), it would have the right to freely assign or sublet the property as though it was the fee owner of the property. Of course, it is not the fee owner of the property and sophisticated Landlords would like to maintain control over who is paying them, with creditworthiness being the main concern. However, the parties can often reach a compromise, providing the Tenant with some flexibility.

With respect to assignments, the Tenant will want to be able to freely assign the lease (without the consent of the Landlord) to one or more of Tenant's affiliates and subsidiaries. In connection with corporate restructurings where the ultimate control and ownership of the operations and the tenancy are not changing, the Tenant should have the right to make these named changes in its operational discretion. The same situation goes for a subletting to an affiliate or subsidiary. The Tenant would argue that the Landlord "shouldn't care."

For other assignments, the Tenant will want objective criteria for the Landlord's approval such as net worth, business experience, and not being a direct competitor of the Landlord. While it usually is not the intent of the Tenant to escape a long-term ground lease by way of third-party assignment, the Tenant will want very specific and attainable standards for

what the Landlord will agree to if the situation arises requiring this action. This also applies to a subtenancy, although if the Tenant is always to remain primarily liable under the lease, then it may argue the Landlord shouldn't have too much heartburn over the subtenant.

### **Casualty/Condemnation**

A Tenant would rest its head easy at night with a casualty provision that simply provides that all proceeds in a casualty are payable to Tenant and that all awards in a condemnation are also payable to the Tenant less the reversionary interest of the Landlord. Unfortunately, there isn't much easy rest to be had in negotiating these long-term leases since both parties are likely experienced enough to see how things go wrong without specificity.

Although made in jest above, the casualty provision should be pretty clean. The Tenant is the one who improved the premises and insures the building and improvements thereon. There is no rent abatement for a casualty and the Tenant is the one depreciating the assets on its balance sheet. Accordingly, the Tenant should be awarded and should *control* all proceeds in a casualty. Where a Landlord and its lender asked to be made loss payees, a Tenant will certainly object since there is no reason to disrupt the autonomy of the lease simply for accidental destruction and break the chain of control of the premises until the end of the lease. Additionally, the Tenant will likely balk at a Landlord's request for the Tenant to hold business interruption insurance since the Landlord is due rent without abatement and it is the Tenant's business discretion as to how to plan and pay for this contingency. Finally, a sizeable tenant with a strong credit profile will often want the right to self-insure, which should be acceptable to the Landlord since it is again the Tenant's business operational autonomy which is being preserved with this option.

Condemnation can be more easily contemplated given the overall estate stack associated with a ground lease (expressly including mortgagees of the fee and leasehold estates). Although best practice is

certainly specificity in drafting, a punt may be best here. Simply stating that each party is entitled to petition for award based on its interest in the property may be the easiest way to avoid costly negotiations and be constrained to a calculation which ultimately leaves a party with gaps in its anticipated return.

### **Landlord Default**

Admittedly, it seems silly to talk about the default of the Landlord when this section of the article has preached Tenant autonomy and posted a figurative "Landlord Not Welcome Here" sign. However, the Landlord still can be a bad actor for actions which have a negative effective on the premises such as blocking access points or placing obstacles in parking fields which negatively affect the operations of the Tenant. In this instance, the Tenant will almost always want a self-help right. To stay on theme, the Tenant cannot be put in a position where its operations are affected by an act of the Landlord who shouldn't be affecting such operations.

Furthermore, the Tenant will want to negotiate the Landlord's mitigation duties in the event of a *Tenant* default. Re-letting obligations along with any assessment of the fair market value of lost rents is certainly a hot topic for negotiation in the early stages of lease discussions and the Tenant should ensure that since it is the higher risk-incurring party, there are ways to protect itself in the event the situation goes south.

### **LEASEHOLD FINANCING**

While the focus of this article is mainly on the relationship between the Landlord and Tenant and the considerations of each party to be made when entering into a long-term, single-tenant ground lease, the financing portion of the leasehold estate is sometimes the only way to make the deal happen or to entice the Tenant to enter into the lease knowing that it has the option to lever its interest.

Commercial real estate lenders view leasehold collateral as "higher-risk" collateral in relation to collateral owned in fee, as a negative event occurring

under the Ground Lease could impair the lender's collateral for the underlying financing. Accordingly, a leasehold mortgagee will look for certain protections to be embedded in the Ground Lease (or an ancillary agreement with the fee owner) to ensure that the collateral for the leasehold financing is protected. These protections, if not included in the Ground Lease already, can be incorporated through an ancillary agreement or amendment to the Ground Lease.

Depending on the type of financing being obtained (with capital markets financing being more restrictive as to the requirements), the list below may serve as a checklist for provisions to be included in some form or fashion to make the lease "financeable":

- Adequate Lease Term (A Fully Amortizing Loan has a term coterminous with maturity date of loan while a Non-Fully Amortizing Loan has a term extending significantly beyond maturity date of loan (e.g., 20 to 30 years));
- Leasehold estate expressly permitted to be encumbered by leasehold mortgage;
- Lease may not be modified, amended, cancelled, terminated, or surrendered without consent of leasehold mortgagee;
- Leasehold mortgagee is entitled to receive a copy of all notices sent to leasehold Tenant under the Ground Lease and no such notice is effective unless dually served to such leasehold mortgagee;
- Leasehold mortgagee has the right to: (i) cure all defaults of leasehold Tenant; and (ii) extend any applicable cure period for such time as necessary in order to acquire the leasehold estate, if such acquisition is required to effectuate a cure; the fee owner shall waive all non-curable defaults following a leasehold mortgagee's acquisition of leasehold title;
- Ground Lease assignable to leasehold mortgagee upon foreclosure/assignment in lieu of foreclosure without fee owner consent (and further assignable thereafter without consent) with the leasehold mortgagee entitled to exercise all rights of leasehold tenant following acquisition;
- Casualty proceeds are held and applied in accordance with the terms of the leasehold mortgage loan documents;
- Fee and leasehold estate are each entitled to their own condemnation awards and condemnation awards attributable to the leasehold estate are held and applied in accordance with the terms of the leasehold mortgage loan documents;
- Leasehold mortgagee entitled to a new lease upon termination of the Ground Lease *for any reason* expressly including rejection of the Ground Lease in a bankruptcy or pursuant to any other law affecting creditor's rights. The new lease shall be of equal priority as the lease prior to its termination, rejection, or disaffirmation;
- Fee estate to remain unencumbered during the term of the Ground Lease, or fee mortgage cannot be superior to the leasehold estate;
- No merger of the fee and leasehold interests if ever held under common ownership;
- Leasehold tenant has the right to freely sublet the leasehold premises;
- Fee owner agrees to provide an estoppel to future leasehold mortgagees;
- There are no current events of default under the Ground Lease; and
- The fee owner has no preferential rights of first refusal or options to purchase which could prime a leasehold mortgagee's rights. 📌