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Is Your Ground Lease "Financeable?"

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While ground leases can be both useful and practical in real estate transactions, a ground lease will be economically viable only if it has terms (often referred to as "mortgagee protection provisions") facilitating the tenant's ability to finance the development of the land with a loan secured by the tenant's leasehold interest in the property. Following is a summary of some mortgagee protection provisions typically sought by lenders when financing ground leasehold interests.

Initially, the ground lease should give the tenant the right to grant to a lender a security interest in the tenant's leasehold estate without the landlord's consent. Because a ground lease tenant's development generally contemplates subleasing space to third parties following the completion of development, the ground lease also should provide the tenant with the right to sublease space without the landlord's consent. Likewise, the ground lease should permit the lender to freely assign its interest in the ground lease should it acquire the leasehold estate.

The term of the ground lease also will be an important consideration in obtaining leasehold financing. Depending on the loan repayment terms, a lender may require the term of the ground lease to extend anywhere from ten (10) to twenty (20) years beyond the maturity date of the loan, giving the lender sufficient "cushion" to either sell its interest in the leasehold estate to another developer in the event of a foreclosure, or, with respect to construction or bridge financing, to attract a new lender to refinance the existing debt.

The determination of the ground lease rent and provisions for its increase are key considerations for a lender in determining the value of the leasehold estate. Ground leases providing for rental increases difficult to quantify in advance, such as adjustments based upon future fair market value determinations, may create challenges for a lender in underwriting the value of the leasehold estate. In contrast, fixed increases in ground lease rent provide an avenue for a lender to more accurately assess the value of a ground lease.

A ground lease also should include the broadest possible permitted use provision to maximize its value. Ideally, the tenant will have the right to use the property for any lawful purpose, but in any event the tenant should attempt to obtain a broad property use clause covering reasonably anticipated development. From a lender's perspective, a broad use provision may enhance the marketability of the property in the event of a foreclosure to allow a subsequent purchaser to reposition the property based on market conditions which may not have been foreseeable to the landlord and tenant at the time the parties originally entered into the ground lease.

Because a lender's security interest in a ground lease will be eliminated if the ground lease is terminated, lenders will require that landlord provide lender with notice of an event of a default by the tenant under the ground lease and grant the lender a period (usually longer than that provided to the tenant under the ground lease) to cure the default. With respect to defaults which by their nature require the lender to be in possession of the property (e.g., failure of tenant to repair damage), the lender's cure period should include the time required for the lender to obtain possession of the property. Any tenant defaults which cannot be cured by the lender should not result in the termination of the lease so long as the lender continues to pay rent and diligently prosecutes all curable defaults to completion. Subject to lender's cure, the ground lease should also grant to the lender the right to obtain a new ground lease on the same terms and conditions as the existing ground lease in the event of a termination of the ground lease as a result of a tenant default not susceptible to lender cure (e.g., tenant's abandonment of the property or dissolution).

Under the common law doctrine of merger, if the holder of a lesser estate acquires the greater estate, the two estates merge. Thus, a ground lease must contain an anti-merger clause to avoid the risk of the lender's security interest in the ground lease being eliminated if the tenant acquires fee title to the property (e.g., pursuant to a purchase option in the ground lease).

A ground lease also should address the treatment of a casualty or condemnation event during the lease term. Among other terms, a lender typically will require control of any casualty and condemnation proceeds in order to insure that the premises will be satisfactorily restored following a casualty or condemnation to preserve the value of the lender's collateral. Lenders often will require casualty or condemnation proceeds to be held and applied pursuant to the terms of the deed of trust, with proceeds allocated between the fee and leasehold interests.

Finally, a financeable ground lease should require the landlord to provide an estoppel certificate upon the request of the tenant's lender, pursuant to which the landlord certifies all matters relevant to the lender regarding the ground lease, such as whether rent payments have been paid current by the tenant, the effectiveness of the ground lease and commencement of the lease term, and whether any default by the tenant has occurred or any offset rights have been exercised under the ground lease. To the extent not provided by the terms of the ground lease, the estoppel certificate may also seek to address any other issues related to lender's financing requirements, effectively amending the ground lease terms.

There are numerous other mortgagee protection provisions, such as the effect of a tenant's lease rejection in a bankruptcy case, which merit consideration when negotiating a ground lease. Involving counsel experienced with ground lease financing issues at the outset of ground lease negotiations will assist in structuring a financeable ground lease adequately protecting the interests of the landlord, tenant and lender.

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