

GROUND LEASES

By: Mark Tipperman, Lawyer

What is a Ground lease

- Hybrid comprised of typical space lease and ownership of fee simple title.
- Lease of land but may already be improved
- Almost always ground landlord has no obligations with respect to the land and improvements
- Generally long term leases – proverbial 99 year lease

Where are ground leases found – examples:
manufactured home parks, cell towers, solar farms,
windmills/turbines, restaurant and retail pads,
condominiums (if statutorily authorized), office
buildings, industrial parks, publicly owned land,
First Nations reserve land.

Why a ground lease – no upfront cost to tenant, often better cash on cash return over the short term, ground rent deductible as an expense, some owners may be willing to ground lease but not sell, landlord may be unwilling to bear expense of improving or altering land or even paying tenant improvement allowance to cover part of tenant's improvement costs, landlord looking for annuity equivalent, ordinary income over long term vs. immediate capital gain upon sale, governments may be prohibited from selling or may as a matter of policy prefer ground leases for various reasons including some continuing control over the property.

Why no ground lease – more problematic financing leasehold, selling leasehold, subleasing – no financing if remaining term is insufficient, diminishing asset at some point in lease term even if market value of the land and improvements have increased significantly. Because of the length of the typical ground lease, future fluctuations in land value, net income, tenantability and legally permitted use of the leasehold cannot be projected.

When negotiating or reviewing a ground lease, a lawyer needs to perform the same **due diligence** the lawyer would perform for a fee simple acquisition, plus negotiate or evaluate the ground lease, as applicable, preferably using a checklist or equivalent, summarize the lease and point out any significant issues to the client in writing and highlight the risks posed – Good practice to review ground lease ASAP especially key provisions

	Ground Lease	Space Lease Non-Credit Tenant
Rent	Formula determined escalations in rent to landlord typical; or fixed rent escalation. All property expenses	Fixed rent escalation, plus often pro rata share of certain property expenses or increases in certain property expenses
Use	Any legally permitted use	Moderately restricted or very restricted permitted use
Assignment	Freely or nearly freely assignable	Subject to landlord's consent
Financing	Authorized and lease lender protected	Permitted on tenant personal property

Subordination	No to fee mortgage	Yes to fee mortgage
Alterations	Freely permitted	Subject to landlord's consent
Insurance Proceeds	Controlled by tenant's lender, available for repair/restoration	Controlled by landlord's mortgage lender
Restoration	Tenant obligated to restore or raze	Landlord discretion to restore or raze
Defaults	Notice, extended cure periods, tenant lender cure rights	Notice, tighter cure period, no tenant lender cure rights
Insurance	Tenant maintains property insurance	Landlord commonly maintains property insurance
Recordation	Memorandum / Notice of Lease	Prohibited

Rent paid to Landlord:

Initial rent: rent might not accrue for a period of time and/or at a reduced rate for a period of time

Fixed/Base/Minimum Rent: alternatives of (i) fixed schedule with risk of inflation or deflation; (ii) cost of living adjustments; (iii) a market value or income formula; (iv) a combination – throughout or could be fixed increases initially with escalation provision later in the term

Keep rent escalation provision simple

Include examples of calculation in the lease

Have second lawyer review clause

Parties held to their lease agreement despite the absurdity of the outcome

Begusic v. Clark, Wilson & Co., 1990 CanLII 646 (BC SC), considered a ground lease where the annual fixed rent could have “increased in a range of 1700% to 3200%.”;

Ground Rents Weigh Down High-Soaring Icons, “Leases signed long ago are causing challenges for building owners as rents reset”, Keiko Morris, The Wall Street Journal, June 11, 2019

Rent Case Law

"fair market value of the Leased Premises as bare land" must be interpreted in this case as necessarily inferring that the valuation be done without reference to the lease and consequently without reference to the restricted use [as a hotel only] found in the lease.

to determine the "fair market value of the demised lands" ... [I]f the Tenants are legally restricted from benefitting from the [condominium] development potential of provisions in land use legislation affecting the Lands, such development potential should be disregarded in appraising the fair market value of the Lands.

Literally construed: "The party desiring * * * appraisal shall give written notice to that effect to the other party * * * except that in case of any appraisal ... with respect to the first renewal term and the second renewal term, neither party shall give such written notice to the other party earlier than twelve (12) months prior to the expiration of any such renewal term"... [**resulted in rent determination 32 years after renewal term began**]

[G]round lease which states that, in an appraisal for purposes of fixing rent, the appraiser must regard the land "as vacant, unimproved and unencumbered by this lease", precludes consideration by the appraisers of the use restrictions upon the leased property ... Under the quoted language, the appraisers cannot take into account anything to do with existing improvements, which necessarily include the encumbrances related to the landmark building and the building on which there is a lease to which the ground lease is subordinate.”

Rent - Continued

Additional rent: tenant pays all expenses of the leased property and improvement, taxes, insurance, maintenance, repair and replacement.

Direct automatic payments to landlord's account to avoid default

No rent abatements for casualty – tenant should always and is usually required to maintain rent loss or business interruption insurance, whichever is applicable.

Use

- Any legal use
- Any legal use except noxious use
- Restrictions on use arising from site with special use characteristics e.g. private medical campus, shopping center, airport, limited access highway, park.
- If use restricted by site with special use characteristic, the use restriction should go away with the special use characteristic – for example commercial airport closes or becomes a charter airport, hospital on the medical campus closes

Assignment

- No or very limited prohibitions
- No landlord consent or very limited right to withhold consent with no consent required for assignment to or by a mortgage lender or at lender's request (foreclosure or other sale).
- Leases often prohibit assignment until initial or pending improvement completed.

Financing. Tenant mortgage should only encumber tenant's leasehold estate and landlord's mortgage should only encumber the fee simple estate subject to the ground lease.

Lease should provide:

- Any fee mortgage subordinate (i.e. postponed) to the ground lease and that any fee mortgage will include a subordination clause.
- Extensive provisions protecting leasehold lenders
- Provision for recognition agreement in favor of leasehold lenders
- Some limited ground lease protection for fee mortgage lender

Any existing fee mortgagee needs to deliver a subordination agreement in favor of the ground tenant.

Residential mortgage closing: Lender's instructions require lawyer to disclose all material facts. All material shortcomings in ground lease or agreement between lender and ground landlord need to be disclosed before loan closes. Some of the most important clauses:

- Lender is to be given a copy of any notice to the borrower at the same time the notice is given to the borrower and no notice to borrower is effective until the notice is given to the lender.
- Landlord will not: (i) terminate the lease; (ii) recover possession of the property; or (iii) exercise any other right or remedy arising out of any breach of the lease unless notice has been given to the lender and lender has a period of time ending after any cure period afforded borrower, for lender to cure the breach. Any breach of the lease which only the borrower may cure (e.g. insolvency) is waived.

- If the lease is terminated by landlord, tenant or any insolvency or bankruptcy trustee, lender is to be given notice and a period of time to exercise a right to enter into a replacement lease on the same terms and conditions as the terminated lease.
- Landlord is to accept the cure of any breach of the lease performed by lender and any exercise of any rights of tenant under the lease, including giving any notice, and exercising any extension or renewal term or pre-emptive right to purchase (e.g. right of first refusal) in the lease by lender.

- Lender may freely assign the lease and may freely enter the leased premises without assuming the lease.
- The lease and lender's leasehold mortgage shall not be subject or subordinate to any mortgage or other security instrument encumbering the landlord's fee simple estate; and any mortgage or other security instrument granted by landlord must expressly provide so.
- Prohibition against merger of leasehold and fee simple estates.

ISSUES IN NOVA SCOTIA PROVINCIAL LEASING POLICY:

5.8 Transfer of Lease

1. Assignment or transfer of a lease to another party requires the prior written consent of the Minister.
2. The executed lease agreement will set out the requirements and conditions under which a lease may be transferred or assigned.

5.9 Termination

1. A lease may be terminated by DNR at any time during the term of the lease if:
 - a. rent or other payments have not been made on the date due;
 - b. the leased property is used for any purpose other than that for which it is leased;
 - c. the lessee fails to submit an Annual Activity Report on time; or
 - d. the lessee has failed to remedy any non-compliance with the lease...

Subleases/Sub-Tenant Non-Disturbance Agreements

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 - If the ground lease is terminated, the subleases remain in effect and rights to possession undisturbed as a direct lease with the ground landlord.
 - Provision for the ground landlord not disturbing subtenants if the ground is terminated, should be included in the agreement between the leasehold lender and ground landlord.
 - Landlord:
 - Wants to restrict the subleases that qualify for non-disturbance, wants right but not obligation to become landlord under qualified subleases if ground lease terminated
 - Doesn't want location or configuration of the subleased space or rents to adversely affect landlord, wants to minimize increased obligations, liabilities.

Defaults: Typical lease default provisions unacceptable. No extra-judicial remedies for possession/re-entry

Guaranty/Security: typically no ongoing guaranty/collateral. Unless a credit tenant, guaranty/collateral generally required so long initial or pending improvement or demolition has not been completed.

Renewals: renewal terms should be exercisable at any time. No lapse of right to renew without reminder notice and additional window to exercise. Ground lease should not preclude tenant from exercising renewal because tenant is in default.

Insurance: lease should require in addition to the then currently available form of “all-perils” or “causes of loss – special form” property insurance covering casualty for full replacement cost with an agreed value endorsement and waiver of subrogation,

Course of construction/builder’s risk during construction and meaningful alterations on a non-reporting form,

Resources for in Depth Coverage of the Topic:

Ground Lease form and separate commentary prepared by the Committee on Real Property Law of the Association of the Bar of the City of New York. To view or download the original unaltered text of this form and a commentary about this form: <https://www.nycbar.org/for-the-public/legal-forms-and-resources/real-estate-forms>. These documents are available both in Word and PDF.

A Guide to Ground Leases: (with Forms and Checklists), Joshua Stein, ALI-ABA, 2005
(a two volume updated version is expected later this year or 2020)

Commercial Ground Leases (3rd Ed. 2018, Supplement August 2018), Jerome Whalen

Questions ?