

GROUND LEASES – AN OVERVIEW

Introduction

What is a ground lease – a hybrid comprised of typical space lease and ownership of fee simple title. Lease of land but may already be improved, almost invariably the ground landlord has no obligations with respect to the land and improvements, generally long term leases – proverbial 99 year lease, often shorter and sometimes longer. Often renewal terms. In some instances, a developer landlord may provide some limited infrastructure or even a ready to build compacted pad.

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.

Where are ground leases used – examples: manufactured home parks, cell towers, solar farms, windmills, restaurant and retail pads, condominiums, 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 less than five years for Canadian residential mortgage, less than 30 years for commercial mortgages, diminishing asset at some point in lease term even if market value of the land and improvements have increased significantly, potential landlord bankruptcy risks.¹ 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.

Simplistic Comparison of Provisions in Ground Leases v. Short Term Space Leases with Non-Credit Tenant

	Ground Lease	Short-Term Space Lease, Non-Credit Tenant
Rent	Formula determined escalations in rent to landlord typical; or fixed	Fixed rent escalation, plus often pro rata share of certain property

¹ Romspen Investment Corporation v. Woods Property Development Inc., 2011 ONSC 5704 (CanLII), bankruptcy receiver authorized by lower court to sell bankrupt landlord's property free and clear of Home Depot ground lease, modified on appeal 2011 ONCA 817 (CanLII). But see: Business Development Bank of Canada v Adventura II Properties Inc. et al., 2015 ONSC 5026 (CanLII): "The settled authority, since 1960... has consistently been that the authority granted to a trustee under [Bankruptcy and Insolvency Act] s. 30(1)(k) does not extend to the disclaimer [termination] of a lease on behalf of the landlord, unless such authority is specifically granted by provincial law."

	rent escalation. All property expenses	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 or demolition	Controlled by landlord's mortgage lender
Restoration	Tenant obligated to restore or raze	Landlord discretion to restore or raze
Defaults	Notice, extended cure periods, leasehold lender cure rights	Notice, tighter cure period, no leasehold lender cure rights
Insurance	Tenant maintains property insurance	Landlord commonly maintains property insurance
Recordation	Memorandum / Notice of Lease	Prohibited

Issues of Particular Significance in Ground Leases

Rent –

Initial rent: rent might not accrue for a period of time and/or at a reduced rate for a period of time, perhaps to give tenant opportunity to perform due diligence, obtain permits, obtain construction financing, construct improvements, enter into sublease(s) and begin collection of rent under sublease(s)

Fixed/Base/Minimum Rent: alternatives of (i) fixed schedule with risk of inflation or deflation; (ii) cost of living adjustments; and (iii) a market value or income formula to either or both mitigate inflation and share increases in value, for example a percentage of rent income after debt service and taxes, or net income, simplicity of formula important, give examples of calculation. The case law construing rent increase clauses based on changes in value make it clear that **there is no other clause in a ground lease which should command more careful attention when drafting a ground lease.** ² There may also be a combination of the alternatives, some fixed rent increase with a

² No. 100 Sail View Ventures Ltd. v. Janwest Equities Ltd., 1993 CanLII 477 (BC CA): “[T]he phrase “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. In my opinion if the parties intended to include as a factor in the valuation of base rent the restricted use they would have expressly said so in words that would have modified the words “bare land.””

Archdiocese of New York v. Amedeo Hotels Limited Partnership, 295 A.D.2d 161 (1st Dept. 2002): The motion court properly determined that the provision in the subject ground 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 at issue, since those restrictions are

potential for additional increases based on value or income. Increases based on value can be dramatic.³ Courts may hold the parties to the strict letter of their lease agreement despite the absurdity of the outcome.⁴

The ordinary tension between a landlord and tenant in negotiating a rent clause in a ground is exacerbated by the lengthy term of the lease, the significant risk to the landlord that the gap between the lease rents and the potential market income will substantially widen over time, and the landlord's recognition that landlord will usually realize a windfall if the lease is terminated early. This is to be contrasted with the negotiation between a space lease landlord and a tenant where the lease term is

inextricable from the existence of buildings, and are therefore excluded from consideration by the words "vacant" and "unimproved"... 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.”

Board of Regents of Victoria University v GE Canada Real Estate Equity, 2014 ONSC 7435 (CanLII) summarizing Revenue Properties Co. v. Victoria University, 1993 CanLII 9432 (ON SCDC): “ In this proceeding, the arbitrators were required to determine the “fair market value of the demised lands”...*Revenue Properties* held that, without clear language, the Court should not find an intention of the parties to take into consideration in the determination of fair market of the Lands any potential value that the Tenants could not exploit due to the fact that their interest in the Lands is a leasehold interest.** [I]f the Tenants are legally restricted from benefitting from the 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. On this basis, Revenue Properties would require that the valuation of the Lands be conducted excluding the potential for a freehold residential condominium project on the Lands by virtue of the restrictions in the Condominium Act, 1998 on the Tenants’ use of the Lands for such a project.

In Revenue Properties, Id. : the lease clause at issue was “appraise and determine the fair market value of the demised lands.** There are no clear words stating that the demised lands are to be valued "irrespective of any improvement made thereon by the lessee"... Nor are there qualifying words such as "as if free and unencumbered"...or "as if it were unimproved” [citations omitted]** In my opinion, no specific meaning should be given to the word "demised" itself. The present lease should be read as if the word "lands" were being referred to whenever "demised lands" is used.** There being no words to the effect that the lands are to be considered as unencumbered the value must take into account the fact the lands are subject to a lease.”

³ 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

⁴ Matter of Wallace et al, v. 600 Partners Co., 86 N.Y. 2d 543 (1995): “Prior to expiration of the initial term, tenant timely exercised its option to renew under article 16 of the lease, which provides that the rent amount is to be fixed by agreement between the parties or, in the absence of agreement, by an appraisal to be calculated at 6% of the "then value" of the land. When the parties could not agree on a rental amount for the renewal term, tenant sought an appraisal under article 17 of the lease, which provides in pertinent part:

"The party desiring * * * appraisal shall give written notice to that effect to the other party * * * except that in case of any appraisal under the provisions of Sections 16.01 or 16.02 hereof 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"...

The term "expiration" is at the heart of this dispute. If read literally, it requires that the determination of the rent amount for the first renewal term — which commenced on July 1, 1993 — take place 32 years after the term began, in 2025. The effect of postponing a determination of the rent due until 2025 is to freeze the annual rent for the first renewal term at the current amount, requiring tenant to make a lump-sum payment at the end of the first renewal term representing the difference between the amount arrived at pursuant to the retrospective appraisal and the rent actually paid during the renewal term.”

almost always much shorter, risk of future market income gap is smaller. The landlord really wants the tenant to succeed in its leased space, and landlord doesn't want the lease to terminate prematurely.

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

How often to adjust rent - fixed or formula driven

Direct automatic payments to landlord's account to avoid default – typically payments are made by tenant mortgage lender from borrower's account to avoid rent defaults.

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, or restrictions on use arising from site with special use characteristics eg. private medical campus, shopping center, airport, limited access highway, park, waterfront. 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, shopping center closes or use as a shopping center declines below threshold.

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. 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. Ground lease should provide that any fee mortgage is subordinate (i.e. postponed) to the ground lease and that any fee mortgage will include a subordination clause. Any existing fee mortgagee needs to deliver a subordination agreement in favor of the ground tenant. In the worst case from tenant's and leasehold lender's perspectives, the ground lease will be subordinate (postponed) to the landlord's existing fee mortgage but not any future mortgage and only if landlord has obtained a recorded non-disturbance agreement from fee mortgage lender – there is some concern that such a non-disturbance agreement may be avoided in a bankruptcy of the fee mortgage lender.

Landlord: no subordination of fee, some limited protection for fee mortgage lender – fee mortgage lender's collateral includes the ground landlord's estate in the ground lease and the remainder at the end of the ground lease term.

Tenant: no subordination of lease to landlord's financing, no prohibition or significant limitation on leasehold financing, provisions in lease to protect lender with attendant landlord obligation to deliver protective recognition agreement in favor of leasehold lender. If the ground lease is subordinate to the ground landlord's fee mortgage, a default under the landlord's mortgage that results in foreclosure, would extinguish the ground lease (subject to any non-disturbance agreement between ground lease tenant and ground landlord lender). If you are representing the lender and

close a mortgage loan without a protective recognition agreement between the ground landlord and lender – you would be committing malpractice.⁵ A commercial form of recognition/lender protection agreement is included in this presentation as an exhibit to this text. The lease itself must obligate landlord to deliver a recognition agreement in a form attached to the lease or in a form incorporating the equivalent provisions that are set forth in the lease. Leasehold lender should be an express third party beneficiary of the provisions in the lease providing or providing for the recognition agreement.

Impact of rating agency policies very favorable from perspective of tenants and their leasehold lenders. Still not that unusual to find ground leases that come up short even with leases prepared by law firms that presumably know what they are doing.⁶

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.

A recognition agreement between a lender and a ground landlord should have at least the following provisions⁷:

1. At the same time as the landlord provides a notice to the borrower, the landlord must give a copy of the notice to the lender. No notice to the borrower is effective until the landlord provides the notice to the lender.
2. The 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 the landlord gives notice to the lender and provides the lender with a period of time, which ends after any cure period afforded the borrower, for the lender to cure the breach. This does not

⁵ *Gentra Canada Investments Inc. v. Lipson*, 2011 ONCA 331 (CanLII). Malpractice claim was brought by assignee of mortgage lender, who was found to have been assigned the malpractice claim.

⁶ Eg. in a 200+ page ground lease prepared by a nationally recognized law firm in the U.S. the ground lease provisions designed to protect the interests of a mortgage lender are not adequate. By way of example only, they did not excuse a lender from curing defaults that could only be cured by the borrower/tenant, for example dissolution, insolvency, involuntary assignment by attachment or otherwise, no non-disturbance in favor of the tenant's subtenants, did not provide for property insurance in favor of lender and payment of insurance proceeds/condemnation award to lender, lender only entitled to notices of default or termination, no notice of re-entry or other material notices given by landlord, lender only gets 30 days more than tenant to cure tenant defaults – even if curing the default will necessitate getting possession, there is no right to sell the leasehold at a foreclosure sale or assign the lease in lieu of foreclosure without the lender's consent, if the lease is terminated there is no protection against sublease termination or other adverse action by the landlord between the termination date and the date the lender and landlord sign a replacement lease, there is no provision in the lease to ensure that any mortgage granted by the landlord is subordinate to the lease, there is no obligation on the part of the landlord to provide an estoppel certificate in favor of the lender, there is no limitation of the lender's liability under the lease if lender becomes the tenant, etc.

⁷ This list prepared by the author, has in large part been published in the CBA mortgage instruction toolkit, <https://www.cba.org/Publications-Resources/Practice-Tools/Mortgage-Instructions-Toolkit> (CBA membership not required to access)

apply to any breach of the lease which only the borrower may cure (e.g. insolvency); which the ground landlord must agree to waive.

3. Without lender's consent, no modification or consensual termination of the lease or the acceptance of any surrender.
4. If the lease is terminated by the landlord, tenant, or any insolvency or bankruptcy trustee, the landlord must give notice to the lender and provide a period of time for the lender to exercise a right to enter into a replacement lease on the same terms and conditions as the terminated lease for a term equal to the balance of the term of the original lease.
5. The landlord must accept the cure of any breach of the lease by the lender and any exercise of any tenant rights under the lease, including the lender 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.
6. The lender's exercise of any rights under the agreement with the landlord or under the loan documents will not subject the lender to liability under the lease unless the lender acquires the leasehold estate and physically occupies the leased premises or expressly assumes the lease.
7. The Lender may freely assign the lease and may freely enter the leased premises without assuming the lease.
8. When the lender acquires the leasehold estate, the lender will not be liable for any occurrence or breach following the lender's assignment of the lease. Lender's liability in all circumstances is limited to its interest in the leasehold estate.
9. The lease and lender's leasehold mortgage must 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.
10. The landlord must legally acknowledge (attorn to) the lender when the lender acquires the tenant's leasehold estate.
11. The lender is entitled to be named as an insured mortgagee, and first loss payee under any property insurance policy and be entitled to participate in any insurance or expropriation settlement or proceeding.
12. The lender has the right, at any time, to make direct payments of rent to the landlord.
13. The merger of leasehold and fee simple estates is prohibited.
14. Specifics on giving notice and other typical boiler plate provisions must be included.

A review of the recognition agreement form required by one major residential mortgage lender, revealed that a significant number of the preceding provisions were not addressed or not adequately addressed

Improvement/alteration: typically tenant has relatively broad right to make improvements and alterations. Landlord may for example require some qualified right to grant or withhold consent to any new building or voluntary demolition of existing building.

Restoration/repair:

Insurance Proceeds, Condemnation (expropriation) awards: typically available for restoration or demolition, if demolished leasehold lender will insist on being paid off with proceeds. As term winds down, landlord's equity increases and landlord's insistence on a share of proceeds if not rebuilt

Subleases/Sub-Tenant Non-Disturbance Agreements: if the ground lease is terminated, leasehold lender and subtenants want assurance the subleases remain in effect and rights to possession undisturbed as a direct lease with the ground landlord. Leasehold lender will not want to be bound by subleases the lender has not consented to (by conformance with criteria in the loan documents or by lender's consent in a separate writing). 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 if not included in the ground lease. From the subtenant's perspective, execution of a non-disturbance agreement should be provided for in the sublease and if not obtained when the sublease is signed, subtenant needs a right to terminate the sublease if not obtained within a short period of time after the sublease is signed and before subtenant's construction, occupancy and rent obligations commence. Although a subtenant would be well advised to register/record the agreement with the ground landlord, this may not be possible at least in some jurisdictions.⁸

Landlord: wants to restrict the subleases that qualify for non-disturbance, typically wants right but not obligation to become landlord under qualified subleases if ground lease terminated, if landlord does obligate itself to become landlord under sublease if ground lease is terminated then ground landlord: (i) requires that as part of the non-disturbance agreement the sub-tenant is obligated to attorn to the ground landlord as the subtenant's landlord, and (ii) ground landlord 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 don't work. Tenant has very significant investment and the leasehold lender has an even greater investment. Termination of the lease based on tenant default is likely to give ground landlord a windfall. Notice to leasehold lender required for notice of default to be effective. Ideally a second notice to lender if tenant fails to cure breach. Never permit or exercise extra-judicial re-entry/recovery of possession. Occasionally find leases that prohibit termination of the lease for anything but rent default – leaving landlord with right to perform defaulted obligations and recover the costs as rent. Leasehold lender must always have right to notice of and adequate opportunity and right to cure tenant defaults. Tenant defaults that only tenant cannot cure must be waived if lender cures all other defaults.

⁸ Edmonton Regional Airports Authority v. Canada Life Assurance Co., 2003 ABQB 754 (CanLII): “The nondisturbance agreement contemplated in the Alberta Land Title Registries Procedures Manual is not analogous to the lease recognition agreement in this case. That nondisturbance agreement in effect creates a “super-priority” for a tenant over a previously registered mortgage, and burdens the land itself. The lease recognition agreement in this case is merely a personal obligation on the City of Edmonton which cannot be registered as a caveat.”

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. Security might be one or more of recourse guaranties, payment and performance bonds, lender set-aside letter, letters of credit or other liquid collateral.

Renewals: renewal terms should 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, rent loss/business interruption insurance, equipment breakdown, building ordinance coverage, perhaps even coverage for interruption of utility services off-site, various liability policies, earthquake/earth movement, flood etc. But consider the prospect that the same or similar coverages may not be available in 100 years or may not be available at rates that make any sense, and that any deductibles/self-retention limits in the lease must be flexible.

Miscellaneous:

Pre-Emptive Rights to Purchase: option to purchase, right of first refusal, right of first offer. Not uncommon to have at least one of these rights. Comprehensive provisions essential. No merger of leasehold and fee estates if exercised as there is any existing mortgage loan.

Dispute Resolution: common to provide for arbitration of certain disputes. Lease should prohibit exercise of termination and re-entry remedies if arbitrated or litigated issue was disputed in good faith and the final non-appealable judgment is complied with within a new cure period.

Recorded Memorandum / Notice of Lease: a must

NS Statutes: subdivision (more than 20 years including renewals), deed transfer tax (21 years or more including renewals): MGA 2(t), 268(2)(i)

Pre-Term/Due Diligence/Permit Contingency Period(s): tenant may seek termination rights with no further unaccrued liability

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 ?