

Friday, November 5, 2021  
10:30 AM- 11:45 AM

Peer to Peer 9

**Ground Rules for Ground Leases: Be careful out there, it's not as easy as it looks!**

Presented to

**2021 U.S. Law Conference  
San Francisco Marriott Marquis  
San Francisco, CA  
November 3-5, 2021**

by:

**Deborah L. Goldman, Esq.**  
Partner  
Belkin, Burden, Goldman, LLP  
1 Grand Central Place  
60 East 42nd Street, 16th FL  
New York, NY 10165  
DGoldman@bbgllp.com

**Kathleen M. Vlasek**  
Partner  
Benesch, Friedlander, Coplan, & Aronoff LLP  
200 Public Square  
Cleveland, Ohio 44114  
KVlasek@beneschlaw.com

I. **Ground Leases Generally**

When the fee owner of land is unwilling (or unable) to sell a parcel of land (which is typically undeveloped, such as farm land), but wants to generate a steady stream of income from the land while retaining the asset to reap long term appreciation in value, a ground lease provides an alternative to the sale of the fee. A ground lease offers the lessee a position similar to that of a fee owner, as a ground lease is generally defined as an arrangement in which the fee owner of real property leases to a lessee some or all of the rights of the beneficial ownership of the tract of real property. Throughout the term of the ground lease, the lessee typically has the right to develop and use the property. These rights include constructing improvements and enjoying the economic benefits of the development, while assuming those obligations a fee owner would generally be responsible for (e.g., paying taxes, insuring the property and improvements thereon, handling all maintenance and repair, including landscaping and snow removal and making additions and replacements that might otherwise be considered capital expenditures).

A ground lease usually involves leasing a tract of real property without improvements and separates land ownership from improvement ownership. This means that undeveloped land is leased to the lessee together with broad rights with respect to the development and occupancy of the land, including being permitted to build a building and make other improvements throughout the lease term.

A ground lease can benefit both parties for many different reasons. For the lessor, there will be no taxable transfer of the property for income tax purposes. The lessor retains its ownership of the property and will receive a stream of income from the lessee's rent without the ongoing ownership duties required in a space lease. For the lessee, there will be no large capital commitment to purchase land, but the lessee has the opportunity to develop land for their purposes and to their exact specifications and receive the benefits of "owning" the property.

However, the ground lease may come with restrictions and controls imposed by the ground lessor in order to assure that the use and quality of the development will provide the economic returns and the use of the land and standards for development satisfy the long term goals of the ground lessor, who will ultimately regain possession of the land at the end of the term (or sooner if something goes wrong!)

## II. Ground Lease as compared to a Space Lease

The significant difference between a ground lease and a space lease is the position in which the lessor and the lessee are placed, which affects multiple aspects of a lessee's interest in the leased premises.

Ground leases are created under the concept that the lessee will be creating improvements on the property and then generally using the improvements to run a business along with managing all aspects of "ownership" of the property. Space leases are usually "turn-key" or "as is" in that the improvements to the land are already made and the lessee is renting the space within the improvement (although the lessee may be required to make specific improvements within their space prior to commencing operations).

**First**, the question of each party's rights and obligations to the leased premises and the larger property, if any:

In a space lease, the lessee leases and occupies a portion of a larger building or development owned, constructed, and managed by the lessor, sharing rights to the remainder of the building and property with other lessees and the lessor. The lessor remains required to perform ongoing obligations related to the property, including paying taxes directly, carrying insurance, and being responsible for ongoing maintenance and repair obligations within the common areas of the property and the structural and exterior portions of the buildings, with the lessee being obligated to reimburse the lessor for their share of the costs incurred for these obligations. In addition, while the lessee in a space lease has a right to use the remainder of the property on a non-exclusive basis, the lessor generally has broad rights to operate the property as it determines, including making changes to existing buildings, constructing additional buildings, modifying parking and access ways, and using the non-building areas for sales areas or promotional events. A lessee may have some rights to limit the lessor's rights, but the level of control here will depend on the lessee's bargaining power when the lease is being negotiated.

In a ground lease, the lessee leases the entire parcel and any improvements thereon, whether constructed by the lessor or the lessee (although typically the lessee will be responsible for constructing all improvements or completing significant alterations and improvements to any previously existing improvements), and will have sole obligations and rights related to that ground parcel. The lessee will be responsible for all maintenance on its leased property, including maintenance of the grounds (e.g., snow removal and landscaping) and of the improvements thereon, including interior, exterior, and structural portions thereof. The lessee will typically pay taxes directly (or reimburse 100% of all taxes allocable to the leased parcel and the improvements thereon if the lessor elects to manage tax payments) and will insure the leased parcel and its improvements. The lessee will have broad rights to manage the ground leased parcel as it sees fit (albeit usually with some lessor approval for material changes) and the lessor will usually have a much more hands-off approach to ownership than in a space lease and no rights to use or modify the leased parcel. In a situation where a ground leased parcel is part of a larger development, there may be some carry over with non-exclusive rights to use the remainder of the development in common with other lessees and the lessor, but the specifics of any shared obligations will be treated similarly to fee owners of adjacent parcels where such obligations are addressed in an REA or Declaration.

**Second**, how the improvements of a lessee pursuant to its lease will be treated during the term and after expiration:

In a space lease, as noted above, the lessee is taking possession of a portion of a larger building or development. The lessee will make improvements within its leased space to allow it to operate its business in the manner it intends, but subject to the lessor's approval as to the scope of such improvements. During the term of a space lease, the lessee will remain responsible for those improvements and may be required to remove its improvements upon the expiration of the term and return the leased space to the same condition as it was upon delivery by the lessor. The specifics of a lessee's obligations related to its improvements will vary lease by lease depending on what is intended by the lessee and what the lessor wants at the end of the term, but typically anything left by the lessee will become the property of the lessor.

In a ground lease, the lessee will take possession of the ground and will typically be solely responsible for all buildout thereon, including, to the extent not already existing, installing utility lines and other infrastructure, developing the grounds, and constructing the building for their operation. During the term of the ground lease, the lessee will own all of its improvements and be solely responsible for their maintenance and repair. At the end of the term, depending on what the parties have agreed, the lessee may be required to raze its improvements and leave the parcel in a specific condition (e.g., paved, grass-covered, etc.) or ownership of the improvements may transfer to the lessor for its future use. Because the lessee is

responsible for the entire property, including all of the structure it constructs thereon, during the term of the ground lease, a lessee will be in a position much like a fee owner who has developed its property. Note that there are likely to be approval rights granted to the lessor, but generally a lessee will have much more flexibility in its development of its leased premises than a space lessee.

**Third**, because of the difference in the obligations of the parties in a space lease vs. a ground lease, the term is usually very different:

In a space lease, the term is usually shorter, typically ten years or less for an initial term, whereas in a ground lease, the term will usually be significantly longer, typically with an initial term of at least ten years, but usually more. A ground lease is also more likely to have a larger number of options after the expiration of the initial term. A “normal” space lease might have an initial term of five years with one or two five-year options, but a “normal” ground lease would have an initial term of ten years with four or more five- or ten-year options. The reasoning for the significantly longer term in a ground lease is due to the greater responsibility of the lessee in a ground lease. The lessee in a ground lease will typically be expending significant funds to construct and develop the leased parcel and needs the ability to amortize the costs of its improvements over a long term and earn a reasonable return on those costs. In addition, if a lessee is getting financing for that development, a lender will require a longer term along with the right to take the ground lease as security for the financing. In this situation, a lender will typically require the term of the ground lease to extend at least five years beyond the maturity of the loan to finance development of the property.

III. **Under a ground lease, who owns the building and other improvements on the dirt, and how does that impact each party’s financial package?**

Throughout the term of a ground lease, the lessee will own any improvements that the lessee makes to the property, such as any buildings or parking structures constructed by the lessee. Additionally, the lessee will be responsible for the cost of taxes, insurance, and maintenance throughout the lease term, in most instances being responsible for direct payment (rather than reimbursement to the lessor of the costs and expenses for these items). This ensures that the lessee is in a position as close to independent fee ownership that the lessee could achieve without actually purchasing the land. It also ensures that the lessor can take on a passive role in which their main responsibility is collecting rent. The lessee’s maintenance responsibility includes all repair and replacement obligations as to not only the interior but all structural components of the improvements. The lessee’s insurance requirements will include property/casualty insurance on the improvements, but the lessor will likely want the lessee to carry liability insurance to cover any third party claims arising from the acts or omissions of the lessee and its employees, agents and contractors, with the lessor being included under the coverage as an additional insured.

After the lease expiration, any buildings or other improvements to the property will belong to the lessor, although the lessor may require the buildings and improvements to be removed prior to lease expiration under the terms of the ground lease, or, alternatively, to put the improvements in a “usable” condition. After lease expiration, the responsibility of taxes, insurance, and maintenance return solely to the lessor.

The lessor retaining the ownership of the dirt means that a substantial financial benefit to the lessee is the elimination of initial land acquisition cost that the party normally would have had to build their improvements.

Construction plans will likely be subject to the approval of the lessor as well as requirements that the construction plans comply with any applicable rules, regulations, statutes, and ordinances of the jurisdiction. Fees associated with approvals for licenses or permits for the proposed construction will be the responsibility of the lessee. The lessor may retain the right to seek these licenses on the behalf of the lessee if the lessee fails to obtain them directly, with the cost remaining the responsibility of the lessee.

The lessor should require the lessee to indemnify the lessor against all costs, expenses, claims, liens, or damages that may emerge out of the construction of the proposed improvements by the lessee.

Depending on the specifics of the arrangement and the terms of the lease, the lessee may be given a construction allowance by the lessor. If this is the case, the lessee will likely negotiate for periodic payments that are released in conjunction with the progress of the construction project. The lessor will also require certain obligations to be met before the construction allowance is released, whether for individual draws or reimbursements or as a lump sum reimbursement, such as completion of the work in line with specified requirements, delivery of waivers and affidavits from contractors and subcontractors ensuring that payment was received in full, and the lessee opening for business in the completed improvements.

In the case of lease termination, the lessee is generally responsible for reimbursing the landlord for the unamortized amount of the construction allowance. This may be in the event of any termination, but can also be limited to only be in connection with a termination due to the lessee's default.

#### IV. **What should the lessor reasonably expect to get back at the end of the term?**

##### A. Casualty: Should there be an obligation to rebuild?

Whether the lessee is responsible for rebuilding in the case of casualty to the improvements on the land is a point of debate when negotiating ground leases.

The fee owner will usually take the position that the lessee has the obligation to rebuild, particularly if percentage rent is to be paid. The lessee will usually take the position that since they are leasing only the grounds, they should not have any obligation to rebuild, but may elect to do so in their sole judgment.

In the event the lessee is provided the right to elect whether to rebuild, the lessee should have the option of whether to rebuild or raze the improvements and restore the land to the same condition as it was at the commencement of the term and continue paying rent. This should be the case regardless of when during the lease term this casualty occurs.

In a ground lease where the lessee is leasing only the ground, any additional improvement to the property by the lessee ultimately be an addition to the lessor's ownership, albeit with ownership not transferring until the lease expiration. This is in contrast to a ground lease where a building may have been on the land prior to commencement of the ground lease. In this situation, the lessor may require in the terms of the lease that the building be there at the end of the lease, effectively not giving the lessee any choice in whether or how to rebuild in the event of a casualty.

Regardless, because the lessee is responsible for insuring the property and all improvements, payment of any insurance proceeds in the case of a casualty will typically go to the lessee. Depending on the lessee's rights to elect whether or not to rebuild, the lessor may include certain requirements related to insurance coverage in the ground lease, including potentially listing the lessor as an additional insured. Additionally, a lender may require that they be named as additional insureds on any insurance policy to ensure insurance proceeds in the case of casualty go towards the outstanding loan amount instead of to the lessor or towards rebuilding.

##### B. Condemnation: How should any award be allocated?

If the property is condemned fully, the condemning authority will pay compensation in exchange for the condemnation. The compensation is then allocated amongst the involved parties, to attempt to put the parties into as close a position as possible as if condemnation did not occur. The allocation of payments is open for negotiation and should be considered when drafting the lease.

The following are a few methods for calculating the allocation:

1. Calculate the fair market value of each of the involved parties' positions at the time of the condemnation. This calculation of the allocation can take into account different issues such as the rent, the remaining term of the lease, the lessee's cost of constructing the improvements, and the cost of the real property itself.
2. Calculate the parties' pro rata contribution to the transaction. This could take the form of a specifically allocated percentage of compensation going to each party.
3. Separate the ground lease into components, such as between the land and the improvements and allocate the compensation accordingly.
4. Allocate first toward the lessee's interests, with the remainder going to the lessor. The lessee would receive compensation for the fair market value of their leasehold interest plus the fair market value of the improvements by the lessee with the lessor receiving the remainder of the compensation including their portion of the interest in the improvements.

Similarly to a casualty provision, a lender may require that they receive the condemnation award up to the outstanding loan amount and that the lease cannot be terminated in a situation of condemnation until the lender has received the outstanding loan amount.

If a property is partially condemned or temporarily taken, the results may be more complicated. If there is a partial condemnation that does not fully affect the leased area in development or operation, there is typically no impact on the lease terms, including on the rent to be paid by the lessee, and the award proceeds will be allocated according to whatever calculation was agreed by the parties.

If the condemnation is more substantial but still not total, the rent may be reduced, typically in proportion to the taking. This consideration may be based on square footage or area taken, but it may also take into account the proportionate impact on the lessee's occupancy and use of the property. In a situation where a rent reduction will be granted, the lessor will want the ground lease to include a provision that the lessor is entitled to seek compensation from the condemning authority to offset the loss of rent.

If there is a temporary taking, in most circumstances the lease will remain in effect with no rent abatement or reduction. In this situation, the lessee will generally receive the compensation proceeds, unless there is a portion of the compensation allocable to periods extending beyond the remaining lease term. In this situation, those proceeds would be payable to the lessor.

V. **How does a Ground Lease structure affect financeability of the project - for both parties?**

A lender that provides financing for the buildings or improvements to the real property to the lessee will use the lessee's leasehold in the land as collateral along with the improvements to the land. A ground lease may prove more difficult to finance as opposed to financing projects on a fee owned property because commercial real estate lenders see this leasehold collateral as higher risk. This is because a negative event under the ground lease could impede the lender collecting on collateral for the underlying financing in case of a default. As a result, the lender may seek out lender-friendly concessions from the fee owner in the underwriting of the loan.

In the case of a ground lease, a lessee's lender may seek certain provisions in the ground lease or in ancillary agreements directly with the fee owner to ensure that the collateral for the financing is protected. These provisions may include, but are not limited to: adequate lease terms; the leasehold estate being expressly permitted to be encumbered by a leasehold mortgage; restrictions on the lease being modified without consent of the lender; and no right of first refusal to the fee owner.

One of the key factors that would affect the financeability of the project is whether the ground lease is subordinated or unsubordinated. In a subordinated ground lease, the lessor's fee interest in the land is of lower priority when it comes to lender financing. This means that if the lessee defaults on a loan for the construction of improvements on the land, the lender could go after the property, including the land, as collateral. In an unsubordinated ground lease, the lessor's fee ownership is of higher priority than other lender when it comes to claims. This means that if the lessee defaults on a loan, the lenders cannot go after the land. The lender can usually only go after the assets of the business, such as the improvements on the property.

A lessor will have the ability to finance or refinance the property in connection with a ground lease. In particular, the ground lease will likely be a benefit, as the lessor's lender will view the rent income favorably in connection with the terms of the loan. If the lessor defaults, its lender will have the ability to foreclose on the property and take it subject to the terms of the ground lease, including the ability to collect the rent from the lessee. A lessee under a ground lease will push for a non-disturbance agreement from a lessor's lender, however, to ensure that its interest in the property will not be disturbed in connection with any default by the lessor.

VI. **How does a ground lease structure affect the availability of termination rights under the lease - for both parties?**

The most common situation for termination of a ground lease is expiration of the lease. Another situation of allowed termination would be in which the parties to the lease mutually agree to surrender the lease. Generally, a breach or default under the ground lease may also be grounds for termination.

Termination upon default is typically considered standard in a normal lease, but in a ground lease, if there is financing involved, the lease will almost certainly contain provisions that protect the lender. This means that the lender would be able to prevent or cure defaults to avoid losing the value of the leasehold or fee interest (depending on whether the lessee or lessor has financed the project) so that it could be sold to a third party. In the case of ground lease termination, the lender will likely want the right to have a new lease with the successive owner on the same terms without any approvals or negotiations.

Ground leases may also include specific termination rights or automatic termination in specific circumstances. For example, if the lessee does not use best efforts or due diligence to obtain the necessary approvals under the agreed upon plans and specifications of the property or if the lessee has not commenced or completed its work within a set period following execution, the lessor may have the right to terminate. In addition, in the case of a condemnation where the leased property is vacant and the condemnation occurs prior to the start of improvements to the land, the ground lease may provide the lessee with the option to surrender its interest to the lessor. Or if the lessee declares bankruptcy and the bankruptcy trustee rejects the ground lease, then it may be terminated. The associated claim for rent accrued before rejection by the lessor would have priority in the bankruptcy proceedings as an administrative expense.

Generally, ground leases survive the death of either party. It is usually contemplated that the ground lease will extend beyond the death of at least one party, if not both, and the lease responsibilities will pass to the heirs of the parties.

## VII. **Other common lease provisions subject to modification for a true ground lease:**

### A. Use

Lessors will generally want a narrow use of the land and to review any changes to the land to ensure that no restrictions on the use are violated. Usually, there are construction provisions in the lease that limit the lessee's ability to build anything besides what is expressly agreed to. If the lessor owns the property adjacent to the land covered by the ground lease, the lessor's desire for narrow use may also be to limit competition to or be in accordance with the improvements on the adjacent property.

The lessee will generally want as broad an allowable use of the land as possible. This ensures that if the lessee wants to assign the lease or sublet the land, that the assignee or sublessee will be able to use the land as they want to.

### B. Term

Ground leases generally tend to have very long terms in comparison to other types of leases, such as 20-40 years. Ground leases up to 99 years are not uncommon.

The long lease term is because the lessee of a ground lease will often be constructing improvements on the leased land and so the lease term must be long enough to not impede these improvements as well as long enough to amortize the cost of large improvements. This amortization allows for meaningful use of the land by the lessee, meaning that the lessee can generate income from the improvements and pay for them while realizing a return.

Then length of the lease term is often governed by the use proposed for the tract of real property and also by the financing obtained by the lessee for the project. As indicated, a lender may require that the ground lease has an "adequate" term - which is usually five to ten years beyond the maturity of the loan.

Instead of a long term, the parties may instead agree to a shorter term with multiple renewal options. This may be a desirable point of negotiations for the lessee because in the event that their operation is not successful, the lessee can end its rent obligation sooner. In this case, it may be desirable for the lessor as well, to pre-emptively avoid a default by the lessee.

## VIII. **Ground Lease as compared to Fee Ownership**

Fee ownership is the most complete form of real property ownership. A fee owner receives title to the real property, which includes both the land itself and the improvements on the land. This means that the owner

can possess the land and improvements and do with it as they see fit. This also means they can dispose of it under whatever terms they wish, including sell it, lease it, or hold it until it passes to their heirs.

Utilizing a ground lease as opposed to a full transfer of fee ownership avoids some complexities and tax implications. While a ground lease is the closest that a leasehold interest could come to fee ownership, it still does not render the same level of ownership and control as a fee ownership. Ultimately, the lessor still owns the land and, at the end of the lease term, owns the improvements as well. Depending on the terms of the lease, the lessee may be subject to certain restrictions or obligations related to its occupancy and operation of the property.