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Seminar 6

DIGGING DEEP INTO THE GROUND LEASE

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Introduction.

To the untrained individual, a lease is a lease is a lease; but to sophisticated individuals and real estate lawyers, there are differences – sometimes subtle and sometimes not – between various type leases. The ground lease is one such type of lease. The distinctive characteristics of the ground lease, and the unique issues that it presents, will be addressed in this material.

As its name implies, this is a lease of land and the landlord and tenant each derive certain benefits, and each accepts certain burdens and constraints, based on this form of lease. It is the tenant that will construct the improvements on the land, but so does a reverse build-to-suit lease and the differences between the two type leases are vast. The ground lease typically is for a greater term of lease, with tenant to be responsible to maintain (and insure) the improvements and with greater flexibility in terms of use. The motivation of the parties to pursue a ground lease will be unique to the parties. In some instances, the owner/landlord may have capital constraints and the desire to deploy capital through other opportunities, or the owner/landlord may not have the experience to construct; and is willing to sacrifice control. And in some instances, the owner/landlord may have an end purpose to sell the ground lease (and the rental stream) to a buyer interested in a Section 1031 exchange and that buyer will pursue the purchase only if there are no obligations to attend to the property; and the ground lease is the safe way to effectuate that objective. The tenant may wish to pursue a ground lease and expend the monies to construct in exchange for lower rent, greater lease term, greater control of the property, and greater flexibility in use.

1. The Two Shopping Center Ground Leases: Ground Lease of Outparcel vs. Ground Lease of Shopping Center. The ground lease is typically utilized in a shopping center setting to cover a parcel of land with a single tenant user. Very often, the parcel is directly in front of the shopping center by the main road or off at either end of the shopping center. In some instances, where a shopping center is quite large, the landlord who is not restricted by parking or other tenant constraints (such as “protected parking fields” and “no build areas”) may seek to create a parcel in which a new building can be constructed. In today’s world, where enclosed shopping malls are being deconstructed and repositioned, a number of small buildings may replace the enclosed mall structure and new uses will revitalize a blighted shopping center; and single tenant buildings – often ground leased – have sprung up. When the topic of ground leases are discussed, this type of ground lease - a single tenant building - is often the focus of the discussion. But the entire shopping center may be subject to a ground lease. A large tract of land may be ground leased by the fee owner and turned over to a developer to create and build a shopping center. In that scenario, the ground lessee/developer will be faced with much different issues. Oftentimes, the ground lease between fee owner and developer will have many contingencies and the contingency period will likely be much longer than the contingencies associated with the ground lease of a single tenant parcel. In this scenario, the entitlement process will need to address all that would be required for the development of a shopping center – site plan approval inclusive of entranceways, and interior drive lanes, permissible building areas and maximum gross

building areas, parking ratio, curb cuts, attendant needs for loading areas, stormwater management, signage, permitted uses and prohibited uses, etc. In the process of obtaining the entitlements, the developer will need to secure anchor tenant(s) (or a critical number of leases) and other requirements that may be imposed by the developer's lender. The developer will need to juggle and satisfy multiple parties – the local planning board, perhaps County, State and Federal regulators, the local building department, potential tenants and lender – and the fee owner will need patience while all of this plays out. Of course, like a purchase and sale arrangement, the developer may have to pay non-refundable monies to the fee owner until the overall contingencies have been satisfied or waived. Assuming that the contingencies are satisfied and the shopping center is constructed, the ground lessee/developer will need to lease to viable tenants and the ground lease itself will need to permit the ground lessee/developer to manage, control and operate the shopping center as if it was the owner, with little constraints imposed by the fee owner. The fee owner may be quite willing to afford the ground lessee/developer the control that it requires, but the fee owner may have concerns that an absentee owner does not have. The fee owner could own adjacent land that it wishes to develop itself. For example, the fee owner may intend to construct an office building or residential units, and would not want the shopping center to (a) compete with those uses or (b) operate for certain uses – noxious or otherwise – that might adversely affect the fee owner's project. The ground lessee/developer may also want to control and restrict other property that the fee owner owns or may own. The ground lessor and the ground lessee will need to address the concerns of the parties in the ground lease itself (and perhaps also in a reciprocal easement type agreement). Some fee owners may not have nearby project concerns but they may be focused on the long term effects of the shopping center. If the fee owner is a family that has owned the real estate for generations and has no interest in selling the land, as it is looking out for the next generation or two or avoidance of capital gains tax, the fee owner may be willing to ground lease the land for shopping center use, but they may be focused on what happens in 50 years or so in the future when the ground lease term comes to an end. If they are astute, they will want to assure themselves that the property can be converted to the best use at the time; perhaps it will be a shopping center or perhaps it will be another use. The fee owner may or may not be willing to permit tenancies to go beyond the ground lease term, and the fee owner may or may not want the improvements to convert to their ownership or be demolished. All of these concerns and scenarios will have to be addressed in the ground lease. A variation of this is when the fee owner ground leases a tract of land that will be developed by the ground lessee but retains land that it intends to develop or lease to a particular type of tenant. One such scenario is when the fee owner retains a parcel that it intends to lease to a grocery supermarket and ground leases the other parcels to the ground lessee/developer for shopping center or mixed use purposes. In this instance, we can expect that the fee owner will wish to restrict the uses, building heights and signage that can be placed on the ground leased parcels to respect the restrictions that the supermarket tenant will likely impose on the fee owner and on the adjacent land.

2. **Entitlements; Conditionality of Ground Lease; Timing.** As the parcel is likely undeveloped (although it is possible that the parcel is currently improved but the parties intend to demolish the improvements and construct a new building), it is quite likely that governmental entitlements will be necessary to effectuate the ground lease. At the same time as entitlements are being pursued, there will likely be a due diligence period afforded to the ground lessee to ascertain such things as soil conditions, any hazardous material upon the parcel (or upon the shopping center that could migrate upon the parcel), zoning, building code requirements, anticipated cost of construction, and the like. Some retailers may feel the need to have a drive-through lane or outdoor seating area, others have particular concerns about trash enclosure (size and/or location near the expected placement of the building, but not too close where offensive odors find their way into the building); and knowing the likelihood or unlikelihood during the due diligence period could short circuit the deal. While the due diligence period may give the ground lessee the quick right to terminate the lease, it is quite likely that the entitlement process will afford both parties to re-consider the deal. It should be expected that site plan approval will be required, and the approval process will require planning board approval unless the shopping center owner, in a prior process, had the site pre-approved subject to certain conditions. If the parcel was pre-approved, there will 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. If the parties are able to satisfy all of those conditions, then the site has already been entitled. If there are some conditions that are being violated (such as re-placement of the building outside of the approved footprint), the landlord and tenant may merely need an administrative process to get permission, or it may require a full blown approval process for site plan amendment. If the parcel had not been pre-approved, it can be expected that site plan approval will be necessary and the parties should be prepared for that (and the ground lease will need to be specific on the process). The ground lessee will likely know the range of what it needs for this site to work (e.g., building size between 4,500 to 5,000 square feet, building height of 22' – 24", outdoor patio area, a drive-through lane where customers can order and receive their food, and a certain minimum number of interior seats to serve the restaurant facility). If the entitlements come up short of the ground lessee's expectations, the ground lessee (and probably the ground lessor) will have the right to terminate the lease. The parties will need to work in concert and in coordination to achieve site plan approval. The ground lessor would be well served if the ground lease contained a floor plan and site plan with designations attached to the lease and a range of necessary

parameters; this is the “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 that is attached to the lease, then the ground lessee will not have the right to terminate the lease. Of course, the ground lessee may not be able to, or willing, to attach to the lease a safe harbor set of drawings, in which case the ground lessor may seek to refer to another existing facility as the safe harbor with language to the effect that if site plan approval is granted as will permit the building to be substantially similar to the ground lessee’s existing facility located at a certain location, then the ground lessee shall not have the right to terminate the lease and the lease shall remain in full force and effect.

Timing of the due diligence and site approval processes will vary from location to location. In some instances, this can be accomplished in a matter of months; in other jurisdictions, a matter of years. The parties will need to work together and be fair and reasonable. From the ground lessor’s perspective, if entitlements are dragging on, the parcel is not producing any revenue and if there is not a strong likelihood that the deal will proceed soon, the ground lessor may wish to terminate the lease and move onto an alternative plan. From the ground lessee’s perspective, there may be a need (whether generated by Wall Street if the tenant is a publicly traded company and not meeting its store opening objectives, or internal requirements) to pursue another opportunity if entitlements are not achieved within a reasonable period of time based on the circumstances.

3. **Section 1031 Exchange.** Real estate, as an asset class, enjoys a unique tax deferral strategy through Section 1031 of the federal tax code. A real estate owner is given the opportunity to sell real estate and defer capital gains tax by purchasing a like investment (i.e., another interest in real estate) if that party identifies the real estate that he/she/it intends to buy and then actually closes within a certain period of time. While there is movement afoot to repeal this tax deferral strategy, there is a strong lobby group (probably the International Council of Shopping Centers being one of many) to challenge the repeal. Single tenant ground leases have a huge following among Section 1031 buyers. The buyers are typically those that look upon these deals as an alternative to fixed income bonds. In this case, instead of clipping coupons, they collect and deposit rental checks. The ground lease offers a perfect vehicle for this: the ground lessee is responsible to pay real estate taxes directly to the municipality; the ground lessee is responsible to maintain, repair and insure the building and often the area outside of the building; the ground lessee must pay rent under all circumstance, including a casualty. Essentially, in a true ground lease, the ground lessor has laid off all responsibility with respect to the building and other improvements, and with respect to the real estate itself, to the ground lessee. If the ground lease is drafted properly, it is an attractive vehicle for a Section 1031 buyer. The real estate attorney representing the ground lessor should view the lease through the lens of a Section 1031 buyer, to ensure that the ground lessor has no responsibility toward the operation of the property. As an alternative to bonds, the attraction of the Section 1031 buyer will center around lease term and the creditworthiness of the tenant. A common approach to achieve adequate lease term has turned to 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 ground lessor 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 ground lessor.

4. **Lease Term.** One of the most distinctive aspects of the ground lease is the lease term. The typical length of the term creates issues in terms of use rights, transfer rights and rent that ripple through the remainder of the lease.

As noted above, since the tenant is required to perform construction and since the tenant may not want to invest time and resources in due diligence until it has a signed lease, ground leases are often subject to conditions relating to the ability of the tenant to develop the property as anticipated. These conditions are often freely 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. Thus, while the tenant is exploring its ability to get appropriate governmental approvals, building permits, operating approvals, etc. or its ability to negotiate purchase or lease of adjacent property, to obtain satisfactory financing, etc. these “conditional” periods may be expressed as “pre-terms.” During the due diligence period the tenant may have reduced or non-existent rent. Obviously while the landlord may be willing to address this valid tenant need it is crucial for the landlord that the tenant meet deadlines to satisfy conditions or the landlord must have an option to terminate the lease. In addition, the landlord should require tenant to diligently pursue required inspections, permits, etc.

A similar issue will arise with respect to rent concessions during the tenant’s anticipated construction period with the tenant seeking a reduced rent proposing that the landlord’s return will be generated once the building is up and operating. The landlord’s response on these kinds of requests will hinge upon its economics and expectations. What are the landlord’s carrying costs? At a minimum landlord will seek to have those met. How long is the landlord willing to take the property off the market while its tenant performs due diligence and forego other potential tenants?

What compensation does landlord want for that loss? What is the likelihood that tenant meets the conditions? All of these will impact the landlord's cost/benefit analysis in deciding the conditions of any 'pre-term' for the tenant.

The original operating term for a ground lease can vary greatly although the standard assumption is that it will be substantially longer than a commercial lease. While maximum term of 99 years is very common, terms for a ground lease can be as short as 10-20 years (even including options to renew) and some states permit leases to be renewed forever without violating the rule against perpetuities. The driving force determining the term of a ground lease is the underlying economics. The question for the tenant is, "How long will the tenant need to open-- to pull permits and construct any planned improvements, etc.-- and how long after such improvements are constructed will the tenant need to operate them in order to recoup its costs and generate the return it anticipated?" Generally, the tenant will want to achieve those required returns during the initial term rather than run any risk associated with a renewal term. From the landlord's perspective, the driver on term decisions will be the tradeoff between "certainty" of rental income (which remains, of course, subject to credit risk over a long lease term) vs. control and opportunity cost. How long is the landlord willing to commit to a fixed rental stream when a greater rental stream might be possible? As we discussed in considering the determination of fair market rents, the potential for a different use to potential generally benefit terms is substantial over a long-term ground lease.

Renewal terms are obviously 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 real meat of the discussion in this area is the renewal rent. Most landlords will be far less concerned about the length of time that the tenant may occupy the property so long as they are confident that they are not losing out on potential value. In a standard commercial lease, fixed rent increases, whether expressed in dollar terms or percentages, are common. But the long length of the typical ground lease term as well as the goal of many ground 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 gain leverage because if rent is undermarket at the time of renewal they can renew and take advantage, and if it is overmarket they can simply relocate or renegotiate with landlord while threatening to relocate. The advantage grows when considering the long term and flexible uses typically associated with a ground lease.

Landlords want two kinds of protection: first, against the risk of inflation. This area of concern can be addressed by simply requiring a CPI provision. The CPI negotiation is simple and not the subject of this lecture but landlord should be aware that it is only addressing one potential driver of future rents. The second concern is addressing opportunity costs. There are two components here. First, the market rent for the existing use may have increased. This is simply addressed by a standard fair market rent provision. But in addition, at the time of a renewal the property originally used for one retail use may be better suited for another type of retail use or for a different non-retail use altogether. This leads to a discussion on highest and best use which is a lot more complicated. In a traditional commercial lease the calculation of fair market will often include a reference to the permitted use. For a single use ground lease that might be appropriate as well or for a lease of a shopping center the standard might read "for a retail shopping center." However, the landlord of a ground lease 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 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 and so will seek a "highest and best use" standard. 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, ground tenants should be aware that if it rents vacant land and constructs improvements at its 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.

5. **Definition of Demised Premises.** To state the obvious, the premises conveyed by ground lease are primarily the ground itself. In a ground lease for an entire shopping center the area subject to the ground lease is likely to be a large, unoccupied piece of ground on which the tenant will construct all improvements. In an outparcel ground lease construction may be limited to items from the curb of the driveway in or even just to the building itself. Depending on the nature of the ground lease, certain existing improvements may be conveyed with the ground lease, whether infrastructure such as utilities or stormwater controls or even above ground improvements. The landlord may require tenant to maintain those improvements or to demolish those improvements or landlord may not care. But the primary driver is to value of the ground and that the cost of major improvements and to be borne by the tenant. This means that the landlord's investment and return are reduced, which then tenant's investment are correspondingly increased. If the premise is part of a larger shopping center controlled by landlord the tenant

may seek to have protections such as use restrictions and access that extend far beyond the premises and the parties must agree on a mechanism to provide these protections.

In addition, as a part of and a condition to the delivery of the premises, the tenant may seek from landlord certain warranties. These are traditionally heavily negotiated and bear some resemblance to commercial leases, but also have significant differences. The tenant may want a warranty that whatever infrastructure or other improvements it is relying on are in good condition or that the premises may be occupied for a certain use or have a certain zoning. In a ground lease as in a commercial lease a landlord may balk at making representation that a tenant can research itself. With regard to environmental warranties, Landlord must consider these very carefully and take exception to all issues that it is aware of pursuant to an environmental report. Landlord must also be sure it does not undertake responsibility for the behavior of previous owners, or even for materials that may migrate onto the premises, but instead warrants simply to agree that the landlord itself will not contaminate. The landlord may, of course, seek a corresponding warranty from the tenant. In a ground lease situation there is generally an easy give for a landlord that will not be anticipating many on-site obligations. There may well be warranties that the tenant seeks from the landlord on title and survey costs. As a general rule, a landlord must seek to reject as many warranties as possible and invite the tenant to get a survey, to provide title, to procure title insurance, etc.

6. Construction Obligations – Landlord and Tenant. The most simplistic view of a ground lease is that neither party has any obligation to do any work and the landlord is simply seeking to obtain the rent without any concern regarding construction. But either landlord or tenant may be obligated to perform certain construction as part of its obligations under a ground lease. However, that view is oversimplified in a shopping center context. In many circumstances, the landlord is required to provide certain construction at the premises prior to the ground lease. This is particularly true of the provision of utilities, roadways and other initial improvements prior to the construction of a shopping center outparcel. Those provisions will be governed by applicable covenants and site plan approvals and while a tenant may be willing to undertake such work, a landlord will often seek control of this process. Similarly, the landlord may obligate the tenant to perform building construction. This may happen for several reasons. The first is that the landlord may want the value of the building at reversion and review that as part of the bargain of the ground lease. Second may be a credit concern. The landlord may believe that in order for tenant to pay the rent and for the lease to remain viable, the tenant must complete its work. Otherwise, the landlord is sitting on a time bomb waiting for the tenant to run out of money with property that has not been constructed to generate the kind of income needed to pay the ground rent. Landlord may also seek to have assurance on the timely completion and even opening, particularly if the premises will be an integral part of the shopping center and “leave a hole” in the retail or cause landlord to violate co-tenancy obligations to other tenants.

In the case of an outparcel type ground lease within a large shopping center, the requirements for improvements may be very specific – a prototype building or a building designed to meet a specific use such as a restaurant. Landlord may also require specific controls on parking, landscaping, visibility, building envelope, and height and area limitations. In a shopping center outparcel lease those controls may be negotiated and addressed in the ground lease itself or instead located in restrictive covenants or a similar document governing the shopping center as a whole. Of course, for a ground lease beneath multiple buildings or even an entire center, the tenant will require much more flexibility and the landlord must rely on the tenant’s creditworthiness and experience to ensure that the rent will be paid and that the buildings will be constructed and maintained to a certain required standard.

The landlord may also seek to control the nature of the tenant’s construction by requiring input on tenant’s contractors whether to simply prohibit “bad apple” contractors or to control quality to make it consistent with other buildings at the shopping center. One issue landlord will be very focused on is dealing with avoiding any liens and since the scope of the tenant’s work in a ground lease will be much greater than the scope of the tenant’s work in a standard commercial lease, the risk itself is also greater. Standard commercial lease obligations will apply here. In a ground lease the extraordinary obligations on the tenant are so more extensive than in a standard commercial lease that the landlord may as a result want much more certainty regarding the tenant’s financing, both the existence or even approving terms and conditions. The landlord may require regular progress milestones to be met on construction of the permits and approvals and preparation of plans and commencement or completion of shell work (and in certain cases completion of leasehold improvements and opening). The parties should consider whether the tenant can incur any future special assessments, TIF, or other governmental financing. If so, the landlord may want to retain consent on such future encumbrances on the property and consider what happens if landlord steps into the developers shoes or if the project does not perform as anticipated. Tying into all of these issues is the anticipated useful life that the building is to be constructed. However, in our fast-evolving world it is often the case that the useful life of a building is much shorter than the useful life of the use which drives construction of the buildings. Thus, even outparcel-type ground tenant may want flexibility in terms of rebuilding its initial work if the underlying concept changes, goes out of business, etc.

7. **Delivery Conditions and Timing.** Occasionally a ground lease will require nothing more of Landlord than that it delivers possession of the ground to tenant. But, more commonly, more is required of the landlord. Whether landlord is required to provide onsite construction, adjacent construction of other parcels, offsite construction such as stoplights or merely obtaining zoning for other approvals in a shopping center usually even a ground landlord must usually do something. Many of the tenant's concerns can be address by providing the right to walk away from the deal if it is not satisfied with certain conditions. The tenant must consider the nature and timing of the landlord's conditions in some depth. If landlord is required to do any work prior to delivery, it must of course address the possibility of force majeure on its end and the possible remedies it will grant to the tenant. It should set an earliest possible tender date so it does not have its buildout period start before intended. It must consider blackout dates to avoid opening in holiday. As noted above, these may be expressed as a pre-term or simply be a condition to the deal. If it is a condition, the landlord must, of course, consider which conditions it can commit to meet. Further, the landlord must think long and hard about tying up its property with a possibility that a tenant will not move forward with its deal. A prudent landlord will negotiate extensions for certain force majeure delays and will be trying to avoid commitments that it does not fully control.

8. **Covenants to Construct and Open For Business; Landlord Recapture Rights.** Particularly in a single tenant outparcel ground lease, the landlord may require that the tenant perform construction and open for business at the shopping center. These types of requirements must, by their nature, be more flexible in agreement for an entire shopping center, with minimum occupancy percentages, more flexible deadlines and potential changes in design driven by leasing results. Obviously, one simple concern is time. Landlord wants deadlines as short as possible. Tenants may seek to have those deadlines extended by force majeure, but if the landlord is willing to entertain such an idea, Landlord should be careful to ensure that the concept of "restrictive governmental conditions" is not included in the list of force majeure clauses. Otherwise the landlord then may find its deadline meaningless. Similarly, the landlord may want specific obligations on tenants to diligently pursue satisfaction of the conditions. The question (as so often) is remedy: "What rights may landlord be entitled to if the tenant fails to meet these deadlines?" Or perhaps more importantly, "What remedies will actually help landlord in this situation?" In certain extreme circumstances the landlord may seek the right to step in and exercise self-help to get the conditions satisfied. 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. The tenant is likely to 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. The right to recapture may lead to landlord to own a partially complete building requiring demolition. Having a letter of credit or other source from landlord to collect from may be crucial. Landlords would prefer to have as many rights as possible including of course default; however, a special purpose tenant without a guarantor or letter of credit may leave landlord with no remedy. So landlord negotiates for recapture rights. This terminates the lease and erases any negotiated future income flow, but it may be the best option and if the market has improved since lease execution, this may be considered the best possible option.

9. **Permitted Use; Use Restrictions.** Again, the view on the stereotypical ground lease is that this is simple: "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 have a more restricted use clause. Ground leases may in fact be indistinguishable from inline. For example, a famous national outdoor retailer long preferred to own all of its property rather than rent and thus it would have a ground lease within an inline retail property. Permitted uses for the tenant will be negotiated heavily, butt 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 a long ground lease term. The landlord may respond with limited flexibility, but may also seek to recapture the premise if they go dark or if the tenant seeks to change the use. This use may be particular important for outparcels that may heavily impact the view of the shopping center and they may border nearby roads.

The prudent ground 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 REAs, OEAs, or other documents. The risks of these agreements to the landlord are the same as they are in a commercial lease—the list of the list of potential cotenants grows ever shorter and they may continue to reduce or evolve. However, tenant may seek to have the same protections that it would otherwise in a commercial lease and argue that there should be no reductions simply by the fact that the tenant is building the building itself. Another challenge for landlords may be dealing with ownership of outparcels by parties other than the landlord. When the ground landlord agrees to protect the tenant's use, it must be sure it can enforce such agreements through OEAs, etc.

10. **Signage.** In the site plan approval process, the ground lessee will be keen on addressing signage to make sure that it obtains that which it requires. The exterior building sign will be addressed later in the building permit stage, but any pylon sign, directional signage and signage upon drive-through lanes are addressed earlier in the

process. Some tenants are intent upon obtaining a pylon sign structure on the ground leased parcel, even if the parcel is in front of the shopping center and its building sign will clearly identify the ground lessee; and if a pylon sign structure is not allowed by the municipality, the tenant may look to have a panel on an existing shopping center pylon sign. The probability or possibility of creating a new pylon sign structure on the ground leased parcel may be a real issue for the ground lessor; even if it is attainable, the ground lessor may be resistant to grant such a right in favor of the tenant since its existence may prohibit future pylon signage allowed for the shopping center. Moreover, if the municipality permits such new sign structure, they may require as a condition that the existing pylon signs be upgraded, at a cost that the ground lessor may not be willing to bear (and the likelihood that the ground lessee will bear the cost of upgrade is probably remote). If a new pylon sign structure is not feasible, the ground lessee may look to have a panel on an existing pylon sign structure. The location of the panel, the size of the panel, and the logo/colors of tenant's panel will be a topic of discussion. Directional signs will be dependent on a number of factors, including whether they exist at the time of the lease, the size of the center, and the interior accessways.

The exterior building sign will typically occur during the building permit stage. In some instances, the lease may be contingent upon issuance of a building sign that is consistent with the tenant's prototypical sign, including colors and logo and font type, although the ground lessor will not want to go through the entire entitlement process – and the expenditure of money – to find that the ground lessee can get out of the lease at this stage. These issues should be flushed out before the lease is executed, so that the risks (if any) are known. From the ground lessor's perspective, the ground lessee's signage requirements should be known as will permit existing leases to be checked to see if any conflicts exist (and if conflicts exist, the ground lessee should acknowledge the conflict and determine whether it will accept and assume the risk or modify its signage); and the ground lessee should be made aware of REA-type constraints and determine whether it can live within the restrictions. From the ground lessee's perspective, if the exterior building sign is so critical, it may need to check with the building department or zoning enforcement official to ascertain whether being "subject to applicable laws" will be a problem and whether a variance is possible; and if the REA prohibitions or existing lease restrictions are too restrictive, the ground lessee may want to see if the ground lessor will be willing to seek a waiver from an existing tenant or a co-party to the REA.

In the case where the developer is leasing land from the fee owner for the creation of a shopping center, the issues will obviously be far different. The ground lessee/developer will be dealing with sign structures as part of its site plan approval process, and discussions with the municipality as to pylon signs, monument signs, directory signs and the like will be handled in much the same way as when a developer is looking to develop the entire shopping center through an acquisition.

11. **Parking.** In the case of an existing shopping center where the landlord is ground leasing a pad to a tenant for a single building use, the landlord will first need to know its current parking count and the number of parking spaces that will be lost due to the creation of a new building; and whether the number of parking space after construction will be in violation of code requirement and any minimum parking ratio under an existing lease. Of course, the landlord will need to check its existing leases to ascertain whether the development of this pad site will infringe upon any protected parking area or no build area or required visibility corridor. There may also be an existing lease that permits the creation of new outparcels upon the condition that the outparcel has "self-maintained" parking. This means that, based on the contemplated use, there are a certain number of parking spaces upon the outparcel that is consistent with code or the requirements under the existing lease (e.g., 4 parking spaces per 1,000 square feet of gross leasable area for non-restaurant use, 5 parking spaces per 1,000 square feet of gross leasable area for restaurant use). The ground lessor's attorney will need to be cognizant of these facts in order to properly address the issues.

In terms of the construction process, the landlord will have concerns about such things as (i) control of construction debris, (ii) location and duration of the construction staging area, (iii) diligent and continuous construction activity to bring the construction project to conclusion, (iv) prohibition of exterior construction activity during certain months of the year [note: not unusual for leases to prohibit exterior construction during the months of November and December]; and (v) no overnight parking and construction vehicle parking only in certain areas.

In the case where the developer is leasing land from the fee owner for the creation of a shopping center, the issues will obviously be far different. The ground lessee/developer will be dealing with parking as part of its site plan approval process. The developer may seek to push the municipality that current code requirements are archaic and are not reflective of the evolving state of retail centers given the change in uses and the advent of e-commerce. The fee owner may, however, wish to push for more parking, particularly if it has adjacent property that it has, or will, develop and the fact that cross-parking easement may be sought.

12. **Maintenance and Repair Obligations: Pad versus "Curb In" vs. "Building Only."** In a ground lease transaction, the ground lessee will construct the building, utilizing its own designated contractors and building material. While the ground lessor will have certain approval rights (typically limited to height and size of the building, the exterior and structural elements), the ground lessee will have great flexibility to construct what and how it

chooses. The ground lessee will almost always have the obligation to maintain and repair the building. The ground lessor typically delivers the pad (at certain compaction levels) and power lines up to a certain point that will be adjacent to the building; and the ground lessor may have an ongoing responsibility as relates to building settlement and for the power lines up to the point of connection into the building. Then, beyond the building footprint are such things as sidewalks, curbs, parking areas and light stanchions that will need to be created. Ground leases will differ in terms of responsibility of the same. In some instances, the ground lessor may be obligated to make such installations; in other cases, it is the ground lessee's obligation. It would, however, be simplistic to assume that the party who installs is necessarily the party who is responsible to maintain, repair and insure these installations. Some tenants do not want to take on the burden or otherwise believe it would not be cost-efficient to take on this obligation when the landlord can engage their contractors, at a better price, and pass the cost on as a common area maintenance charge. Other tenants are of the belief that they would rather control the maintenance or their franchise agreements require a certain standard and performing the maintenance work will ensure that they are not in violation of the franchise agreement. Some landlords are fearful that the tenant will not maintain its parcel to the same quality standards as the rest of the shopping center, and taking control over the maintenance will ensure that this parcel will look as nice as the rest of the shopping center. Other landlords do not want to be burdened to perform any work, especially those that are interested in selling the parcel to a Section 1031 buyer. In some ground lease transactions, there is an alternative arrangement - "curb-in". In the curb-in deals, the tenant is responsible for the sidewalk, landscaping and lighting directly in front of the building up to the curb, and landlord is responsible to maintain and repair the curb and parking areas beyond the curb.

13. **Casualty.** In almost all ground leases, the tenant is obligated to fully insure the building and improvements upon the premises for full (or nearly full) replacement costs or replacement value. Tenants under ground leases will have the choice to rebuild or not in the case of a casualty. If the tenant elects not to rebuild, it must still raze the structure and remove all debris and leave the site in a clean condition. Unlike a typical net lease, the tenant under a ground lease is still obligated to pay all rent to landlord – the concept of rent abatement is not recognized. Tenants will look for the right to terminate the lease in the case of a casualty that occurs during the last year or two of the lease term. Landlords will be more receptive to this provision if the tenant is still obligated to pay the rent for the remainder of the lease 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.

In ground leases, there may or may not be a right on the part of the landlord to terminate the lease and recapture the premises in the event that the premises is closed for a period of time (e.g. 6 months, 12 months). This recapture right is more common where the parcel is located in a prominent area of the shopping center and the landlord is sensitive to the negative effects to its shopping center if a prominent space is vacant. In such case, the parties will have a different time frame in the case of a casualty. It might result in the tenant notifying landlord of its election to rebuild within a certain period of time after the casualty occurs, commencing to rebuild within a period of time after the casualty, or completing the rebuild within a period of time (or any combination thereof). If the landlord elects to recapture, the parties will have to attend to a few issues, including an assignment of the insurance proceeds to landlord and 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).

In a typical non-ground lease, the landlord may well have the right to terminate the lease if there is substantial damage to the shopping center, whether there is damage to the premises or not. That concept is not typically found in a ground lease. Tenants under a ground lease may nonetheless have the right to terminate its lease if there is substantial damage to the shopping center (or a critical zone); this of course will depend on the size of the shopping center, the location of the ground leased parcel to the general layout of the shopping center, and the negotiation leverage of the parties.

14. **Financing; Non-Disturbance Agreement (both Ground to Term and Lender-Related Lender.** Financing for ground leases is much more likely to operate on multiple levels than typical commercial lease. While a standard commercial lease will allow Landlord to mortgage and address an SNDA, and may grant 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 ground owner is likely to want to encumber its property. The tenant needs to finance construction of the building. In an outparcel there will be adjacent owners and their lenders. The result for the prudent tenant and landlord will be 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, when the ground tenant/building landlord defaults under the ground lease and the ground landlord is ready to step into the building landlord shoes, how do you resolve the discrepancy between obligations? The ground landlord would prefer to keep clipping coupons and have no obligation to perform any maintenance, repair, or other obligation typically required of a landlord under a standard

commercial lease. The commercial tenants, of course, are not going to be willing to continue to pay building rent and get none of the building services they negotiated for. Similarly, the ground landlord of a shopping center parcel might find that after ground tenants/developer default it is stepping into multiple different leases (likely with ongoing landlord defaults) in order to keep the property running. The (now defunct) ground tenant/developer has undertaken credit risk on multiple smaller tenants in a failed center. The ground landlord will now trade the single credit risk from the much larger and more credit worthy ground tenant/developer for multiple credit risks for small businesses. Another issue: Is the ground landlord willing to allow the tenant's building lender to step in to the lease. The ground landlord may be relying on an experienced operator for a specific use. The lender will not have the experience to run the kind of store in question and thus may be a much less attractive tenant. But surely the lender will require the right to foreclose and occupy the property so a balance must be negotiated. How about the ground landlord's lender? Are they willing to step into the ground landlord's obligations? Almost certainly the ground landlord's lender underwrote the loan assuming those obligations were limited to clipping coupons. But what happens if they are forced to step into a non-disturbance agreement between the ground landlord and one of the building tenants: These issues must be addressed slowly and methodically and with charts keeping track of how various responsibility flow. Ideally these negotiations will take place with all the players at the same time. In any event, it is a big challenge.

15. **Condition Upon Surrender at End of Term.** As a matter of course the landlord will want to make sure that at the end of the term there is no environmental contamination or other waste committed to the property. The concept is no different than a commercial lease, but the risks are higher with a ground lease since the tenant will be undertaking all construction and have 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.

Of course, the most obvious issue relating to termination of a ground lease is the condition of the improvements. In certain situations the ground landlord may require the return of vacant land and the parties must negotiate to address costs and timing. 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. The landlord counting on 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 situation where the tenant may well need to re-develop the building over time to keep generating income or where the 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 may demolish the building and re-purpose 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.

16. **Right to Purchase; ROFO/ROFR.** There are limited instances where tenants under a ground lease will be granted the right to purchase the parcel. If a right to purchase is granted to the tenant, there are several things that will need to be factored. In the first instance, the right to purchase must be limited to the premises only; the tenant cannot have a right to purchase any other part of the shopping center. Second, there will need to be certain exempt transfers, including the sale to an affiliate of the landlord or a multiple parcel transaction that crosses multiple shopping centers, and a transfer involving the current lender, whether through foreclosure, deed in lieu of foreclosure, or otherwise. Indeed, the right to purchase may be in violation of the landlord's loan documents or may trigger a release/payment to the current lender that makes the right to purchase completely unacceptable to the landlord. The time period will need to be set. It is not uncommon for the right to purchase to have a certain window period after the initial lease term. The purchase price will usually be based on fair market value, and how fair market value is defined and the method and procedure of making the determination is subject to intense negotiation. Do you take into account the best use of the parcel, or the current use? Do you factor in the "as is" condition of the building or the expectation that the building will need upgrades? Do you have a minimum purchase price floor, or a maximum purchase price ceiling? Will the broker that procured the tenant be entitled to any commission, and do you factor in the commissions or the lack thereof as part of fair market value? If the purchase is effectuated, the parties will likely need to create and record a set of easements and restrictions to enable the parcel to operate within the boundaries of the shopping center (including a set of use restrictions, access and cross-parking easements, etc.), with the new buyer now subject to contributions for common elements that serve both the parcel and the shopping center. Needless to say, a right to purchase will not be acceptable to a ground lessor that intends to sell the parcel to a buyer as part of a Section 1031 exchange.

In many respects, a right of first offer and a right of first refusal will involve similar issues and concerns as an outright purchase option. It will be a little more palatable since, under the ROFO or ROFR, the landlord is interested in selling the property and the lender concerns have been factored into the analysis to sell. The right of first refusal is generally regarded as less palatable since it is viewed as having a chilling effect on potential purchasers, although under a ROFR the purchase price has been established and accepted to the landlord-seller. Of course, the right of first refusal will require the tenant to accept all of the salient terms of the accepted offer when, in fact, that may not be possible.

17. **Protection under a Recorded Instrument**. In the case of a ground lease of a single parcel, it is expected that a memorandum of lease will be issued and recorded. The ground lessee will, after all, want the world to be aware of certain key provisions of its lease, including use restrictions and rights granted to the ground lessee, and restrictions imposed by the ground lessee. This protection needs to be weighed and measured by any burdens that a recorded memorandum of lease may impose. The State of Maryland, for example, imposes an economic burden upon the recording of a memorandum; and other states, such as New York, Massachusetts, Pennsylvania and California, will tax a lease as a conveyance if the lease term plus options exceed a certain number of years.

In the case of a ground lease of tracts of land that will be developed as a shopping center, it may be necessary that the fee owner who owns neighboring land and the ground lessee create and record a COREA (construction, operation and reciprocal easement agreement) or some like instrument to preserve their rights and establish obligations owed to the other party.