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Workshop #16

**WHY ARE YOU STILL SINGLE?
THE TOP CHALLENGES TO BUILDING A SUCCESSFUL LONG-TERM
TENANT AND LANDLORD RELATIONSHIP IN A SINGLE-TENANT GROUND LEASE.**

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Introduction

We all know that ground leases are a special kind of challenge, in which the tenant (the “Tenant” or “Ground Lessee”) leases land for a very long term. The Tenant controls the improvements on the property during the lease term, but at the end of the term, ownership of the right to use the land and improvements reverts to the owner of the underlying fee interest in the ground (the “Landlord” or “Ground Lessor”). The term and the flexibility on use and the control of improvement can create a tension between the concept of fee ownership and a leasehold interest. The length of the term, the flexibility so great that there is a temptation to have the Tenant control all ownership rights. But, at the end of the term the carriage turns back into a pumpkin and the Landlord and Tenant are left sorting out surrender issues and settling claims.

The Landlord usually seeks to generate income (in somewhat passive fashion), while still retaining the ownership of a parcel of real estate. This allows the Landlord to monetize the value of the land without giving up long-term control.

For the Tenant, a ground lease may be the only way to develop an iconic or important parcel of real estate if (a) it doesn't have the financial means to actually purchase the land, or (b) the owner is unwilling to transfer ownership.

Unlike the development of a multitenant shopping center, a Landlord is typically leasing a parcel of land under one ground lease to a single-tenant user as Tenant (obviously there can be a ground lease under a multitenant development as well, but those ground leases are not the subject of this lecture). As such, given the unique benefits of ground leases for both parties involved, the question “Why are you still single,” in the context of lease variety should not carry the same negative connotation as when asked by one's relatives at family gatherings, though the goal of achieving a successful long-term relationship is similarly paramount. Indeed, for certain landlord-tenant parties, a single-tenant ground lease may be the better option. For the right tenant and landlord, perhaps we should be asking the question, “Why are you not single?”

We will address the distinctive characteristics of, and issues present in, the typical single-tenant ground lease. These are issues that will likely arise, and should be thoroughly considered, when determining whether being “single” whether as a Tenant or Landlord is right for your client.

Landlord Issues

With great benefits and limited detriments, a Landlord may be incentivized to stay “single” through use of a ground lease. Before marrying itself to a single-tenant user under a ground lease, however, the Landlord and legal counsel should consider the following:

Due Diligence/Pre-Construction Investigation and Ability to Build/Open

Typically, the ground lease will have many contingencies, and will be subject to a longer period afforded to the Tenant to confirm its ability to use the premises as anticipated. This is because under a ground lease many of the development obligations (and thus many of the development risks) are transferred to the Tenant. Some considerations will include soil conditions, hazardous material present upon the parcel, zoning, building code requirements, anticipated cost of construction, and the like. This investigation period is commonly called the Due Diligence Period. In addition to conducting pre-construction investigations and obtaining entitlements, the Tenant may also need to meet requirements imposed by the Tenant’s lender, while juggling the satisfaction of multiple involved parties like the local planning board, County, State, Federal regulators, and the local building department. Landlord will need to exercise patience as this all plays out. Like a purchase and sale arrangement, in consideration of the contingency period, the Tenant may have to pay non-refundable monies to the Landlord until the overall contingencies have been satisfied or waived. While the Tenant would rather not incur additional costs if development and proceed as anticipated, without such an agreement the Landlord may be unwilling to allow a long Due Diligence Period during which other offers are missed. A prudent Landlord will reserve the right to terminate the lease if not met or satisfied.

Due Diligence Period Obligations

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. As noted above, since the Tenant is the party responsible for construction and may not want to devote time and resources to 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.

Construction Period

A similar issue will arise with respect to rent concessions during the Tenant’s anticipated construction period. If rent commences prior to the completion of construction of improvements, the Tenant will seek often reduced rent during such period with the understanding that Landlord’s return will be generated once the building is up and operating. The Landlord’s response to these kinds of requests will hinge upon its economics and expectations. What are the Landlord’s carrying costs? Does the rent under the ground lease justify a longer period without rent or with reduced rent?

Landlord Termination Rights

While Tenant, alone, may have the right to terminate the lease during the Due Diligence Period, it is quite likely that the entitlement process will afford both parties the opportunity 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. If either is not received in a reasonable period both Tenant and Landlord might want the right to terminate. On the other hand, if the parcel was pre-approved, there will likely 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. Those restrictions should be acknowledged up front and Tenant should have no right to terminate for a known restriction. If the parcel was not pre-approved, the parties should be prepared to engage in full site plan approval (and the ground lease will need to be specific on the process). The parties will need to work in concert to obtain site plan approval and Landlord may want to the right to seek approvals on behalf of the Tenant so that it’s property was not tied up for a long period of time (the Due Diligence Period) without a right to “save the deal.”

Expectations for Due Diligence and Safe Harbor

The Tenant should know what entitlements it needs for its project, and if the entitlements come up short of the Tenant’s expectations, the Tenant (and probably the Landlord) will have the right to terminate the lease. However, the Landlord would be well served if the ground lease contained a floor plan and site plan with specifications, and a range of acceptable parameters as a “safe harbor”. The condition of this being, if site plan approval is granted within the set parameters and the approved site plan is not materially different from the site plan

attached to the ground lease, then the Tenant does not have the right to terminate the lease. Of course, the Tenant may not be able, or willing, to attach or commit to safe harbor plans at the point its development process when the ground lease must be signed. In this case, the Landlord may alternatively seek to refer to an existing project as its "safe harbor," with language to the effect that if site plan approval is granted as will permit Tenant's project to be substantially similar to the existing project, then the Tenant shall not have the right to terminate the lease on entitlement grounds.

Termination Rights

Of course, once the due diligence is done the parties may desire to terminate the lease. Timing of the Due Diligence Period and entitlement process 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 Landlord's perspective, if entitlements are dragging on, the parcel is not producing any revenue, and there is not a strong likelihood that the deal will progress, the Landlord may wish to terminate the lease and move on to an alternative plan. Presumably, there will be some reluctance to move on as the "alternate" deal is likely to be less attractive than the deal the Landlord initially chose to sign. From the Tenant's perspective, there may be external pressures (whether generated by Wall Street if Tenant is a publicly traded company and not meeting store opening objectives, etc.), or internal requirements to pursue other opportunities if entitlements are not achieved within a reasonable period of time.

Construction and Opening Covenants

Finally, the Landlord will likely require that the Tenant perform construction and open for business. These types of requirements must, by their nature, be more flexible in ground leases that contemplate development of an entire shopping center, with minimum occupancy percentages, more flexible deadlines, and permitted changes in design evolution or tenant concept. Obviously, one area of tension is timing. Landlord wants deadlines to be as short as possible. Tenant may seek various extensions to those deadlines, one example being by force majeure. If the Landlord is willing to entertain such an idea, it should omit the concept of "restrictive governmental conditions" in the list of force majeure events. Otherwise, it may find its deadline meaningless. The Landlord may want to impose specific obligations on Tenant to diligently pursue satisfaction of opening conditions. The question as so often is the 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 self-help rights to step in to Tenant's shoes and satisfy the conditions itself. However, 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 as the Tenant may 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. Likewise, the right to recapture may lead to Landlord owning a partially complete building ultimately requiring demolition. Having a letter of credit or other source from which Landlord can collect may be crucial. Landlords would prefer to have as many rights as possible in the event Tenant defaults in its construction or opening obligations, and a special purpose Tenant without a guarantor or letter of credit may leave Landlord with no remedy. In a standalone ground lease that is not an outparcel to a shopping center there may be more flexibility, but the Tenant may ask itself: If there is no buildings, how would the tenant pay the rent? This is particularly relevant for a single purpose tenant.

Financeability

Financing for ground leases is much more likely to operate on multiple levels than a typical commercial lease. While a standard commercial lease will allow the landlord to mortgage the property, execute an SNDA, and may grant the 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 Landlord will likely want to encumber its property. The Tenant will need to finance construction of the project. In an outparcel ground lease, there will be adjacent owners and their lenders reviewing the lease and making "helpful" comments, which all parties must address. In addition, the question will arise as to what happens if city party defaults in a developmental ground lease with a municipality?

The best option for the prudent Landlord and Tenant will be to execute 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, if the Tenant defaults under the ground lease and the Landlord is ready to exercise its self-help rights by stepping into the Tenant's shoes as landlord of Tenant's tenants, how do you resolve the discrepancy between obligations if a new tenant is now occupying the space? The Landlord would prefer to keep clipping coupons, having no obligation to perform any maintenance, repair, or other duty

typically required of a landlord under a standard commercial lease. Tenant's subtenants, of course, are not going to be willing to continue paying building rent if they do not receive the building services they negotiated for.

Tenant Foreclosure

Another issue is whether the Landlord is willing to allow the Tenant's lender to step into the lease. The Landlord may be relying on an experienced operator for a specific use and a lender is unlikely to have experience running the specified use and is not attractive as a Tenant. But a balance must be negotiated if Tenant's lender is requiring the right to foreclose and occupy the property upon Tenant's default. Landlord's lender, on the other hand, almost certainly underwrote the loan assuming Landlord's obligations would be limited to the proverbial "clipping coupons," but what happens if they are suddenly forced to step into a nondisturbance agreement between the Landlord and one of the project's tenants? These issues must be addressed slowly and methodically with the recommendation that practitioners use charts to keep track of how various responsibilities flow. Ideally financing negotiations will take place with all the players at the same time. What happens if the Tenant is bankrupt? What rights does the lender have if it cannot cure such bankruptcy.

1031 Concerns

Another financing consideration is that single-tenant ground leases have a huge following among Section 1031 buyers. These are buyers that typically look at these deals as an alternative to fixed income bonds. In this case, instead of "clipping coupons," they collect and deposit rental checks. The risk of the buyer is "easily" assessed by reviewing the tenant's credit rating. The ground lease offers a perfect vehicle for this: the Tenant is responsible for paying real estate taxes directly to the municipality, maintaining, repairing, and insuring the project and improvements, and paying rent under all circumstances. Essentially, in a true ground lease, the Landlord has laid off all responsibility with respect to the project and other improvements, and with respect to the real estate itself, to the Tenant. If the ground lease is drafted properly, it is an attractive vehicle for a Section 1031 buyer. The real estate attorney representing the Landlord should view the lease through the lens of a Section 1031 buyer, to ensure that the Landlord has no, or at least very limited, responsibility toward the operation of the property. As an alternative to bonds, the Section 1031 buyer will focus on lease term and the creditworthiness of the Tenant. A common approach to achieving an adequate lease term is 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 Landlord 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 Landlord.

Tenant's Use Clause

In a stereotypical ground lease, the use clause may be as simple as: "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 actually need a use clause just as restrictive as those required by a multitenant lease. This creates more risk for the tenant under a ground lease which may also be undertaking development and approved risks beyond those typically undertaken by inline retail tenants. Permitted uses for the Tenant may be negotiated heavily, and 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 such a long term. The Landlord may respond with limited flexibility, but may also seek to recapture the premises if the project "goes dark" or if the Tenant seeks to change the use.

Exclusive Uses and Enforcement

The Tenant will need to be sure it will not be faced with unreasonable hurdles in its operations and the ground lease itself will need to permit the Tenant to manage, control and operate the parcel as if it was the owner, with little constraints imposed by the Landlord. The Landlord may be quite willing to afford the Tenant the control that it requires, but the Landlord may have concerns that an absentee owner does not have. If the Landlord owns an adjacent shopping center it will not want the ground leased parcel to (a) compete with those uses or (b) operate in a way that would adversely affect the Landlord's adjacent project nearby projects. The Tenant may also want to control and restrict other property that the Landlord owns or may own. The Landlord and Tenant will need to address the concerns of the parties to the ground lease, itself, and perhaps also enter a reciprocal easement-type agreement. Some Landlords may not have nearby project concerns, but they may be focused on the long-term effects. For example, if the Landlord is a family that has owned the real estate for generations and has no interest in selling the land, they may be presently willing to lease the land for the permitted use, but they may be concerned about what happens in the future when the ground lease term comes to an end. An astute Landlord will want to ensure that its property can be put to the best, and most profitable, use at the time; perhaps it will be for the permitted

use or perhaps it will be something else. The Landlord will also wish to restrict the building heights and signage on the parcel subject to the ground lease in order to respect the restrictions that the remainder of the development will expect from Landlord on the adjacent land.

The prudent 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 to the landlord of a commercial lease—the list of potential covenants grows ever shorter and may continue to reduce or evolve. Another challenge for Landlords may be dealing with ownership of other outparcels by parties other than the Landlord. When the Landlord agrees to protect the Tenant's use, it must be sure it can enforce such agreements through OEAs, etc.

Casualty/Obligation to Rebuild

In almost all ground leases, the Tenant is obligated to fully insure the building and improvements upon the land for full (or nearly full) replacement costs or value. Tenants may have the choice to rebuild or not in the case of a casualty, but if Tenant elects not to rebuild, it should still raze the structure and remove all debris leaving the site in a clean condition. Unlike a typical net lease, the Tenant is still obligated to pay all rent to Landlord – the concept of rent abatement is not usually recognized. Tenants may look for the right to terminate the lease in the event a casualty occurs during the last year or two of the lease term. Landlords should be more receptive to this provision if the Tenant is still obligated to pay the rent for the remainder of the ground lease term – particularly as the Landlord may find little advantage in having a tenant-specific building on its land at the end of the 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.

Landlord Recapture Rights

In the event a casualty renders the premises closed for a period of time, the ground lease may grant Landlord the right to terminate the lease and recapture the premises. This recapture right is more common where the parcel is located adjacent to a shopping center, for instance, and Landlord is concerned about the business impact of a vacant parcel. This might result in a lease requirement that the Tenant notify Landlord of its election to rebuild within a certain period of time after the casualty occurs, commence to rebuild within a period of time after the casualty, or completing the rebuild within a period of time (or any combination thereof) failing receipt of that notice, Landlord can recapture. 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 Tenant's investment in the site (with "investment" to be negotiated inasmuch as some cost will be inclusive and others not).

Condition of the Property at Reversion

Of course, the most obvious issue relating to termination of a ground lease is the condition of the improvements. In certain situations the Landlord may require the return of vacant land and the parties must negotiate to address costs and timing. The Landlord may want the security to assure this end or term obligation to avoid having to chase the Tenant. 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 term where the Tenant may well need to redevelop the building over time to keep generating income, or where a 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 plans to demolish the building and repurpose 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.

Contamination and Waste

As a matter of course the Landlord will also 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 has, 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.

Renewal Rental Rates

Renewal terms are 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 crux of the renewal term discussion for ground leases 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 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 benefit both ways: if rent is under market at the time of renewal, they can renew and take advantage of the low rent; if rent is over market at the time of renewal, they can simply relocate, or renegotiate with their landlord while threatening to relocate. The advantage to Tenant grows when considering the long term and flexible uses typically associated with a ground lease.

As such, Landlords should obtain two kinds of protection: Against the risk of inflation, and to address opportunity costs. Protecting against the risk of inflation can be addressed by simply requiring a CPI provision. The CPI negotiation is simple and not the subject of this material, but Landlords should be aware that a) CPIs at best are a rough measure of increases in ground lease rents, and b) CPI is only addressing one potential driver of future rents. In protecting against opportunity costs, there are two components. 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 renewal the property originally used for one use may be better suited for another type of use. 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 rent will often include a reference to the permitted use. However, a Landlord 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 initially 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, Tenants should be aware that if they rent vacant land and construct improvements at their 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.

Renewal rental rates can also be set by arbitration or appraisal. Landlord and Tenant must be careful to specify the parameters for appraisal or arbitration. For example, is the lease itself—and perhaps the existence of other renewal options—to be considered in evaluating the premises? How are the Tenant’s improvements to be considered? As in any arbitration, the question for resolution by the arbitrators should be precisely stated. Although arbitration and appraisal provide some comfort insofar as they are impartial, their goal is usually to set a fair market rental rate within the bounds prescribed by the Landlord and Tenant. The same effect can be reached by prescribing a fair market rental rate for renewal terms.

As one might expect, there is a good deal of litigation about the fair market rent in long term ground leases. There, Landlords make commitments that appear inauspicious 20 or 30 years after the term begins. The Tenants, however, have built costly improvements on the ground and are hardly able to leave. And, whether these costly improvements, as well as other considerations, are included or excluded in an appraisal varies from lease-to-lease and state-by-state.

Tenant Issues

While many of Tenant’s considerations in entering into a long-term single-tenant Ground Lease are inevitably intertwined with the Landlord’s issues described above, since the Tenant is assuming the risk of (in most cases) construction of improvements and the ongoing operations of the leased premises to derive revenue, there are particular concerns facing a Tenant.

Landlord Work/Approvals of Third Parties

Although traditional long-term Ground Leases involve the Landlord doing no upfront work other than being a helpful hand and cheerleader during the Due Diligence Period, some Tenants are now requesting a little bit more partnership from the Landlord. The first area where a Tenant will ask for some participation from the Landlord is in preliminary site work. Since the Tenant may be a multi-location national operator, they may not be familiar with the topographical nature of certain areas of the country and therefore are asking the Landlord for a little bit of risk assumption in the performance of basic site work prior to vertical construction which is to be done to the specification of the Tenant. The cost of this site work may be considered in rent negotiations and/or may require an out-of-pocket contribution from the Tenant, but the Tenant is relying on the Landlord's knowledge of the "dirt" to gain comfort that the site will be made right for development.

Similarly, the Landlord is likely to have a better understanding of the relationships among adjacent property owners, especially in a larger development. Accordingly, the Tenant may ask that, prior to spending dollars during the Due Diligence Period, the Landlord obtain any necessary approvals from third parties in order for Tenant to construct its proposed improvements and operate its proposed business. To be clear, these do not include governmental approvals or permits, but rather if consent is needed under an REA (e.g. architectural review, approval of outparcel tenant, etc.) or from any other private landowner, the Tenant is relying on the Landlord to obtain a "green-light" before investing the time and energy in a Due Diligence Period just to be turned down when a private landowner or approval party says "no thank you" to the proposed outparcel Tenant.

If the Landlord does agree to perform work at the leased premises as described above, the Tenant will be certainly focused on both (i) Landlord's timeline for completion and (ii) remedies available to the Tenant to the extent Landlord fails to complete such work. As far as timelines are concerned, Tenant may bargain for an "outside delivery date" which would be a time by which the Landlord is to complete all of its work. This allows the Tenant to know when it will need to mobilize its construction team and gives a rough estimate as to when they may be able to open their business. A Tenant and Landlord may agree that delivery is not required during the winter months in those states where weather is an impediment to site work and other work. To the extent that the Landlord does not timely complete any work for which it has agreed to undertake, the Tenant will likely seek offset rights (sometimes on a day for day basis) to base rent for delays in delivery and other offset rights to the extent Tenant is forced to complete Landlord's work. Rarely will you see a termination option for failure for the Landlord to deliver, but the financial penalties can mount up and encourage performance.

Permitting Contingencies (Material Changes and Liquor Licenses)

As discussed above, the permitting process can be an arduous process for both the Landlord and the Tenant as the parties are basically in a holding pattern to confirm whether the business terms of the lease can be fully realized by the approval of Tenant's business by the local municipality. In addition to the considerations listed above, the Tenant will pay particular attention to (a) what happens if the permitting authority requires significant alterations to the Tenant's intended improvements and (b) what happened if the Tenant is (with respect to restaurant and bar operators) unable to obtain a liquor license to serve alcohol at the leased premises. With respect to material alterations, a Tenant may bargain for a termination right if the permitting process requires material alterations to Tenant's plans. Many national operators have a prototype building footprint and appearance and if they are not able to open with the same characteristic as many of its other locations, they may not want to move forward with the construction and dilute their brand image. Similarly, since the Tenant holds the risk of operations, if a Tenant is unable to obtain a liquor license to serve alcohol and that is germane to their operations, they may seek a termination right if they are unable to obtain (or if it is economically unfeasible to obtain) a liquor license. In certain states where liquor licenses are limited or sold at auction, this is of particular concern to the Tenant and its budget for the project.

Exclusive Uses (Tenant's Take)

As discussed above, prudent tenants will often seek to prohibit or restrict adjacent properties from operating in direct (or proximate) competition to the operations of the Tenant. In stand-alone parcel deals which are not part of a larger development, the Landlord may not be able to grant any such rights as they may only own the parcel being leased, however, the Tenant may still ask if the Landlord ever does acquire property within a certain radius of the leased premises that they agree not to lease to a competitor, in the spirit that operational success of the Tenant likely keeps the checks coming.

Tenant's may have a list of direct competitors that they may seek to be included in their exclusive use clause, or they may select certain types of operations which they think will adversely affect their business. The Tenant will seek as broad of an exclusive use clause as the Landlord will allow, however, the Tenant's clause is

(basically) worthless unless recorded in a document of record which could either be a Declaration of Covenants or in a Memorandum of Lease in order to put other parties on notice of the granted rights.

What happens to the extent the Landlord violates the exclusive is equally important as the exclusive itself. A Tenant cannot realistically seek to enforce against any party other than the Landlord since the Tenant only has privity of contract with the Landlord, but the ability to seek injunctive relief from a third-party bad actor (a “rogue” tenant) is something worth negotiating for. Ultimately, the Tenant will want to be able to remove itself from the lease entirely in the event of a violation, at its sole election, to the extent the exclusive use violation becomes a determinant to their business. However, if there is not an effect on profits, it is likely the Tenant will want the optionality to stay, as well. Either way, the Tenant is seeking a hammer for the Landlord’s decision to intentionally violate a bargained for right.

Recapture Rights (Tenant’s Take)

We have tried to not mention COVID too much in the article as we are all now acutely aware of its impact, however, the post-COVID tenancy cannot erase it from its memory. Accordingly, from a Tenant’s perspective, recapture rights for failure to operate need a significant runway to keep the Tenant from balking at the clause. In a recapture or termination right situation where the Landlord wants to avoid a “dark – tenant” a Tenant will likely argue, “what’s the problem as long as we are paying rent?” While that statement is certainly meant in jest, there is truth behind it from a Tenant’s perspective. If the cost of operations itself is hurting the bottom line and the Tenant can float the fixed costs of rent, then the Tenant wants maximum flexibility to bide its time until a more advantageous operating environment emerges. Accordingly, a Tenant may ask for the right to be dark for 365 days or more before the Landlord can recapture. Additionally, the Tenant may want the flexibility to complete renovate its business and then reopen to the public with a new strategy following any number of adverse economic events. The more flexibility the Tenant can bargain for with the obligation to pay rent remaining constant will likely comfort the Tenant.

Assignment and Subletting

In the Tenant’s perfect world, since it is the autonomous operator of the premises for a long-term lease, it should have the right to freely alienate this long term right as though it was the fee owner of the property. The only problem with that is that they are not the fee owner of the property and sophisticated Landlords would like to keep discretion as to who is paying them, with their creditworthiness being the main concern. However, middle ground can often be reached by the parties which does provide the Tenant with some flexibility.

With respect to assignments, the Tenant will want to be able to freely assign the lease (without the consent of the Landlord) to any one or more of Tenant’s affiliates and subsidiaries. In connection with corporate restructurings where the ultimate control and ownership of the operations and the tenancy are not changing, the Tenant should have the right to make these named changes in its operational discretion. The same situation goes for a subletting to an affiliate or subsidiary. The Tenant would argue that the Landlord “shouldn’t care.”

For other assignments, the Tenant will like objective criteria for the Landlord’s approval. Net worth, business experience, not being a direct competitor of the Landlord are specific things that a Tenant can likely agree to. While it usually is not the intent of the Tenant to ever escape a long-term ground lease by way of third-party assignment, if the situation arises requiring this action, the Tenant will want very specific and attainable standards for what the Landlord will agree to. This also applies to a subtenancy, although if the Tenant is always to remain primarily liable under the lease then they may argue the Landlord shouldn’t have to much heartburn over the subtenant.

Casualty/Condemnation

A Tenant would rest its head easy at night with a casualty provision that simply provides that all proceeds in a casualty are payable to Tenant and that all awards in a condemnation are also payable to the Tenant less the reversionary interest of the Landlord. Unfortunately, there isn’t much easy rest to be had in negotiating these long-term leases since both parties are likely experienced enough to see how things go wrong without specificity.

Although made in jest above, the casualty provision should be pretty clean. The Tenant is the one who improved the premises and insures the building and improvements thereon. There is no rent abatement for a casualty and the Tenant is the one depreciating the assets on its balance sheet. Accordingly, the Tenant should be awarded and should control all proceeds in a casualty. Where a Landlord and its lender asked to be made a loss payee, a Tenant will certainly object since there is no reason to disrupt the autonomy of the lease simply for accidental destruction and the chain of control of the premises until the end of the lease shouldn’t be broken. Additionally, where a Landlord requests business interruption insurance be held by the Tenant, the Tenant will again put up a fight since the Landlord is due rent without abatement it is the Tenant’s business discretion as to how it

plans for this contingent occurrence and whether or not it deems business interruption insurance an unnecessary expense. Finally, a sizeable tenant with a strong credit profile will often want the right to self-insure, which should be acceptable to the Landlord since it is again the Tenant's business operational autonomy which is being preserved with this option.

Condemnation can be much more contemplated given the overall estate stack associated with a ground lease (expressly including mortgagees of the fee and leasehold estates). Although best practice is certainly specificity in drafting, a punt may be best here. Simply stating that each party is entitled to petition for award based on its interest in the property may be the easiest way to avoid costly negotiations and be constrained to a calculation which ultimately leaves a party with gaps in its anticipated return.

Landlord Default

Admittedly, it seems silly to talk about the default of the Landlord when this section of this article has preached Tenant autonomy and posted a figurative "Landlord's Not Welcome Here" sign. However, the Landlord still can be a bad actor for actions taken which have a negative effective on the Premises such as blocking access points or placing obstacles in parking fields in a development which negatively affect the operations of the Tenant. In this instance, the Tenant will almost always want a self-help right. To stay on theme, the Tenant cannot be put in a position where its operations are affected by an act of the Landlord who shouldn't be affecting such operations.

Furthermore, the Tenant will want to negotiate Landlord mitigation duties in the event of a Tenant default. Re-letting obligations along with any assessment of the fair market value of lost rents is certainly a hot topic for negotiation in the early stages of lease discussions and the Tenant wants to make sure that since it is the higher risk incurring party, there are some ways to protect itself in the event the situation goes south.

Leasehold Financing

While the focus of this article is mainly on the relationship between the Landlord and Tenant and the considerations of each party to be made when entering into a long-term single-tenant ground lease, the financing portion of the leasehold estate is sometimes the only way in which the deal can happen, or which entices the tenant to enter into the lease knowing that it has the option to lever its interest.

Commercial real estate lenders view leasehold collateral as "higher-risk" collateral in relation to collateral owned in fee, as a negative event occurring under the Ground Lease could impair the lender's collateral for the underlying financing. Accordingly, a leasehold mortgagee will look for certain protections to be embedded in the Ground Lease (or an ancillary agreement with the fee owner) in order to ensure that the collateral for the leasehold financing is protected. These protections, if not included in the Ground Lease already, can be incorporated through an ancillary agreement or amendment to the Ground Lease.

Depending on the type of financing being obtained (with capital markets financing being more restrictive as to the requirements), the below may serve as a checklist for provisions which are to be included in some form or fashion to make the lease "financeable":

- ☐ Adequate Lease Term
 - ☐ Fully Amortizing Loan- Term is coterminous with maturity date of loan.
 - ☐ Non-Fully Amortizing Loan- Term extends significantly beyond maturity date of loan (20-30 yrs).
- ☐ Leasehold estate expressly permitted to be encumbered by leasehold mortgage.
- ☐ Lease may not be modified, amended, cancelled, terminated or surrendered without consent of leasehold mortgagee.
- ☐ Leasehold mortgagee is entitled to receive copy of all notices sent to leasehold tenant under the Ground Lease and no such notice is effective unless dually served to such leasehold mortgagee.
- ☐ Leasehold mortgagee has the right to cure all defaults of leasehold tenant and has the right to extend any applicable cure period for such time as necessary in order to acquire the leasehold estate, if such acquisition is required to effectuate a cure.

- ☐ Fee owner shall waive all non-curable defaults following a leasehold mortgagee's acquisition of leasehold title.
- ☐ Ground Lease assignable to leasehold mortgagee upon foreclosure/assignment in lieu of foreclosure without fee owner consent (and further assignable thereafter without consent).
 - ☐ Leasehold mortgagee entitled to exercise all rights of leasehold tenant following acquisition.
- ☐ Casualty proceeds are held and applied in accordance with the terms of the leasehold mortgage loan documents.
- ☐ Fee and leasehold estate each entitled to their own condemnation awards and condemnation awards attributable to the leasehold estate are held and applied in accordance with the terms of the leasehold mortgage loan documents.
- ☐ Leasehold mortgagee entitled to new lease upon termination of the Ground Lease for any reason expressly including rejection of the Ground Lease in a bankruptcy or pursuant to any other law affecting creditor's rights. The new lease shall be of equal priority as the lease prior to its termination, rejection or disaffirmation.
- ☐ Fee estate to remain unencumbered during the term of the Ground Lease, or fee mortgage cannot be superior to the leasehold estate.
- ☐ No merger of the fee and leasehold interests if ever held under common ownership.
- ☐ Leasehold tenant has the right to freely sublet the leasehold premises.
- ☐ Fee owner agrees to provide an estoppel to future leasehold mortgagees.
- ☐ There are no current events of default under the Ground Lease.
- ☐ The fee owner has no preferential rights of first refusal or options to purchase which could prime a leasehold mortgagees rights.