

Leasehold Financing Demands Particular Protective Provisions

Without the right documentation in place, nonperformance of ground-lease terms can create expensive complications for financiers.

BY KARL E. GEIER

Construction and permanent financing of development projects on leased land can pose unique challenges for lenders. Most of these challenges can be better understood if the ground lease is perceived as a senior financial obligation with priority over the project lender's mortgage or other security interest in the property.

Under leasehold financing - which is a form of equity financing - in lieu of purchasing the land, the developer incurs a long-term ground-rent obligation to the landowner, and the owner retains the right to terminate the lease if the ground rent is not paid. While such a capital structure also could be achieved through a purchase and sale of the land with seller financing, the leasehold structure offers an alternative that may be more suitable, or even essential, for certain types of institutional and governmental landowners.

There are various types of leasehold financing. True leasehold financing involves a pledge or mortgage only of the ground tenant's interest in the project, leaving the landowner/landlord in a senior position as compared with the leasehold lender. Most problem areas for the leasehold lender stem from the reality that a senior financial and contractual obligation is first in both time and right to the project financing.

Another type of leasehold financing, somewhat misleadingly known as subordinated leasehold financing, requires the ground lessor/landowner to mortgage or pledge its equity interest in the property to the project lender.

In effect, the landowner subordinates its interest in the property to the ground lessee's lender. While such subordinated leasehold financing introduces a few new nuances, it

is essentially identical to a standard fee-secured loan and offers fewer risks for the lender than are posed by true leasehold financing.

From the leasehold lender's standpoint, a developer's ground-lease interest will be financed only if it meets certain basic underwriting criteria.

First, the ground tenant's interest must be mortgageable - i.e., capable of being assigned or mortgaged to a lender without consent by the landlord, or if consent is required, on terms that assure that both the original project development loan financing and any takeout financing will be approved.

The use restrictions of the ground lease must permit construction, use and operation of the intended project, as well as reconstruction or conversion to another economic use if the original project is damaged or destroyed in a casualty or is economically obsolete.

Curing tenant defaults

Nonperformance of ground-lease terms could result in termination of the ground lease and the complete evaporation of the leasehold lender's primary collateral. Therefore, it is essential that the lease include provisions allowing the leasehold lender to cure tenant defaults under the lease and to take over the property in foreclosure (or have a third party do so) and continue to own, operate and realize the income from the project after foreclosure.

These provisions should include the following:

- a specific right to notice and an opportunity to cure defaults, or in the case of a monetary default, a reasonable period of time to tender the delinquent rent without penalty and the right to institute a receiver and pursue foreclosure against the ground lessee while keeping rent current;

- a reasonable period of time to obtain possession and control of the property before being obligated to cure

non-monetary defaults, which must extend through the full period of foreclosure and afterward, if necessary; and

- A right to preserve the lease, even if defaults by the ground-lease lessee would be otherwise incurable.

Additionally, the lease must allow the leasehold lender to complete foreclosure without triggering anti-assignment clauses in the lease and should provide the leasehold mortgagee with a free right to assign following foreclosure. Any standards imposed upon the identity, financial condition,

use or other qualifications of the assignee must be both practical and capable of being satisfied, as well as precise and not subject to the landlord's subjective judgment or likely to result in disputes.

The term of the lease - as well as the rental obligations and any formula for adjustment over time - must be scrutinized carefully. The term must be sufficiently long to assure that the original project investment with the intended rate of return can be realized.

The rule of thumb formerly was that a minimum term of 75 to 99 years was essential for ground-lease financing. Although shorter terms are now more common, underwriting must take into account the economic life of improvements to be constructed, the time required for return on investment, the investment horizon of any purchaser of the leasehold interest or any subsequent refinance lender and, most importantly, the underlying ground rental and other economic terms of the lease.

These terms must be factored into the required return to determine whether the ground lessee's interest has and will retain value. The timing of cashflow and sources of repayment, including the expected resale or sublease returns, must be consistent with the economic terms of the ground lease, because these amounts will have to be

paid on a priority basis prior to any debt service or principal paydown of the leasehold lender's project financing.

The provisions for disposition of insurance and condemnation proceeds must assure that the investment of the leasehold lender in the project can be recouped and that proceeds will be used to restore the project or to pay down the leasehold loan - at least to the extent of improvements financed by the loan.

Leasehold structures

Development ground leases introduce a new set of special considerations. If the planned means of paying off a leasehold development or construction loan is the eventual subdivision and sale of separate buildings or condominium interests, the prospects for financing the leasehold project also depend on additional ground-lease provisions.

The first issue is subdivisibility. In a large office or industrial-park setting or in the case of residential condominiums offered for sale, the ultimate purchasers will need some degree of independence from defaults by the other users or occupants on the premises.

Depending on the nature of the project, this independence can take on several forms. A truly subdividable ground lease could be split into multiple ground leases so that each purchaser of a portion of the leasehold project receives a direct lease with the landowner/ground lessor, independent of any continuing obligations of other users/ground tenants of the project. This arrangement would allow each of the resulting leasehold owners to obtain its own leasehold financing without concern about cross-defaulted arrangements with the owners of other leasehold interests.

Short of complete subdivision of the ground lease, a form of non-disturbance and attornment agreement will be necessary to assure the leasehold user or purchaser that, so long as the leasehold purchaser or user is paying its share of the ground



Karl E. Geier

Karl E. Geier is a shareholder at Miller Starr Regalia's Walnut Creek, Calif., office. He can be reached at (925) 935-9400 or keg@msrlegal.com.

rent, its right to continued possession and occupancy cannot be disturbed.

If this user or purchaser is to have its own leasehold financing, these provisions must run to the benefit of the purchaser's leasehold mortgagee.

Under this structure, the "purchaser" actually is acquiring a sublease interest rather than an assigned interest in the ground lease. If there is a senior land lender or a leasehold lender on the master ground lease, then both the purchaser/user and its leasehold lender will require non-disturbance and/or rights to cure defaults under the senior loan.

In a condominium project, the ground lessor will need to subject its property to the condominium regime. The availability of conventional mortgage financing (particularly if the loan is to be sold in the secondary mortgage market) will depend upon the leasehold structure's meeting standards established by the Federal Home Loan Mortgage Corp. and the Federal National Mortgage Association.

From a development lender or construction lender's standpoint, the underwriting of such complex leasehold documentation should take into account the limited marketability of complex leasehold interests to ultimate users, as well as the limited availability of financing for such users.

Unlike a standard fee-owned project, the use of more complex leasehold structures exposes a project to bankruptcy risks on the part of a number of additional parties.

Aside from individual user-tenants' bankruptcy, where the considerations for the developer/ground lessee and its lender are similar to other contexts, the developer/ground lessee and its lender must take into consideration the possibility that the ground lessor (or its successors-in-interest) may file bankruptcy.

Under Bankruptcy Code section 363(f), a debtor can sell the property of the estate in bankruptcy "free and clear of any interest in such property" if various conditions are met. In the widely known case of *Precision Industries Inc. v. Qualitech SBQ LLC*, 327 F.3d 537 (7th Cir. 2003), the Seventh Circuit Court of Appeals found that a ground lessor's filing of bankruptcy and subsequent bankruptcy trustee's sale of the leased land was free and clear of the leasehold interests and the interests of the leasehold lenders.

Under section 365(h), the debtor can choose between termination of the lease and continuation of the leasehold if the debtor rejects its unexpired lease of real property and the lessor has a claim against the estate if the lease is rejected.

In *Qualitech*, however, the court found that the trustee could use a sale under section 363(f) to extinguish the lessee's possessory interest without either continuing the lease or compensating the lessee or the lessee's lender

for the terminated leasehold interest.

Two lessons of *Qualitech* for leasehold lenders include the following: First, the lender must control - contractually through the loan documents and preferably in the lease documentation as well - any filings by the leasehold mortgagor/borrower in bankruptcy court. In addition, the lender must monitor and take steps to protect its interests in the event of a ground lessor's filing for federal bankruptcy protection.

Government restrictions

In the case of the ground lessee's bankruptcy, the leasehold lender also must have provisions, preferably in the ground lease, to prevent the debtor in possession or trustee from rejecting the lease and leaving the leasehold lender without a remedy and without collateral for its loan.

The ground lease should require the ground lessor to enter into a new lease with the lender or its purchase in foreclosure in the event that the ground lease is terminated as a result of the ground lessee's bankruptcy. Such new-lease provisions involve complexities with respect to the priority of interests in the real property and should be covered by appropriate title insurance protections.

Finally, governmental entities and other institutional landowners who control properties through a ground-leasing strategy may have legal or other institutional restrictions that affect the ability to finance their projects. A commercial lender asked to participate in such projects should carefully weigh in advance the viability of the proposed structure and the investment results anticipated by the lender.

Program objectives of governmental entities often dictate more severe restrictions upon the identity and qualifications of proposed transferees of the leasehold interest. Such lessors may insist on approval rights that conflict with the leasehold lender's fundamental interest in recouping investment after foreclosure.

These restrictions can make loaning on the leasehold interest excessively risky, unless the limitations lapse with time or can be lifted in some other way. One strategy is to allow the leasehold mortgagee or its purchaser in foreclosure to assign the leasehold without restriction unless the governmental entity pays off the loan or returns the purchaser's investment.

Also, some governmental entities insist upon rights to cure defaults on the mortgage in order to prevent the leasehold mortgagee from foreclosing and acquiring the interest of the ground lessee. Any such restrictions should be carefully evaluated.

Particular care should be taken to avoid lengthy or open-ended time frames for the lessor to cure

non-monetary defaults by the lessee. While unusual, it is possible that open-ended time frames can have the practical effect of precluding the leasehold lender's exercise of remedies and can force the lender to hold an unproductive asset without foreclosing and without the ability to dispose of the nonperforming loan. If so, the lease should not be considered financeable.

Institutional and governmental lessors will be more sensitive to the maintenance of use restrictions, such as long-term regulatory agreements for low- and moderate-income housing or other narrow specified programmatic uses.

Before the leasehold lender commits its resources, these projects must

be evaluated for viability of the original project concept and to assure that viable exit strategies will exist and be permissible under the lease in case of default and foreclosure.

Indian tribes and Native corporations have fostered economic development of reservation lands or other Native properties through a leasehold strategy in order to retain permanent control of the fee simple interest in the land. In these cases, the investment objectives of the ground lessor and those of the private developer need to coincide.

In addition to the other complexities of leasehold financing, dealing with Native properties requires an understanding of additional limitations. ●