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Investing In Ground-Leased Or Net-Leased Real Estate

By **Tzvi Rokeach** (March 6, 2018, 12:21 PM EST)

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This article briefly looks at an issue that continually arises in connection with the financing of ground leases (as well as long-term triple net leases generally), of which any real estate fund looking to invest in such instruments or in property subject to such instruments should be mindful. Unfortunately, as Moody's guidance on the subject[1] points out, while "neither new nor cutting edge," this issue "arises again and again" — namely, the priority of the landlord/fee lender's position vis-a-vis the tenant's leasehold financing. Most real estate lawyers, whether operating in the "dirt" real estate or real estate finance field, know this issue to be pervasive. But somehow, the solution often seems not quite "within the grasp" when fashioning definitive lease documentation.

Basics

First, a brief primer. Ground leases, among other forms of so-called triple net leases, serve an important function in real estate ownership. Often, real estate owners, seeking to monetize unimproved or otherwise developable land but desiring to retain a residual ownership interest, will enter into a long-term "ground lease" under which the tenant typically will lease land and construct improvements upon or otherwise develop the land and then itself operate, sublease or otherwise monetize the land (as so improved or otherwise developed) for the tenant's own benefit; in return, the tenant may pay the landlord upfront consideration and/or periodic rental payments for the duration of the lease term. At the end of the lease term, all interest in the land and improvements reverts to the landlord.

The possible reasons that an owner may ground lease property rather than sell the same outright are numerous and varied, and include tax considerations, a familial or institutional desire to retain underlying control of the land, or simply a desire to collect a stable coupon and generate long-term value. In New York City, in particular, ground leases are an enduring part of the real estate landscape.[2] Ground leases usually are of lengthy duration, often with terms of up to 99 years or even longer, and accordingly are complex, nuanced creatures.

Among other issues that the typical ground lease must address is the financeability of the leasehold position. In particular, because ground leases often involve significant upfront investment by the tenant in connection with construction and/or development of the leased property, the extent to which the tenant's possessory interest in the property for the duration of the term of the lease may be financed and collateralized is of significant concern, and a ground lease's failure to provide the protections that lenders

ordinarily require in order for a ground lease to be financeable will sound its death knell. To be sure, numerous tomes have been written on the ways to make a ground lease financeable; the essentials include ensuring the lease expressly allows the tenant's leasehold interest to be financed and collateralized as a separate interest; providing the leasehold lender with sufficient notice and cure rights in the case of tenant default under the lease (after all, should the landlord simply terminate the lease following the tenant's default, the lender's leasehold collateral will immediately disappear — thus, leasehold lenders ordinarily demand extensive notice and cure periods); granting the lender or its designee the right to enter into a new, replacement lease with the landlord if the lease is terminated or is rejected in bankruptcy; addressing priorities with respect to application of insurance proceeds; restoration following casualty; and various other items.

Financing Priority Puzzle

In addition, the binary nature of a ground lease — insofar as it comprises two distinct ownership interests in a single piece of real estate: (i) the tenant's leasehold interest, together with the income the tenant may derive from the leased property, and (ii) the landlord's post-lease-term residual fee interest, together with the expected stream of rent payments payable during the lease term by the tenant to the landlord, each of which interests may be separately financed by the tenant and the landlord, respectively — presents yet an additional puzzle: to wit, how to address the question of overall priority as between the tenant's leasehold lender's financing and the landlord's fee lender's financing, which are each secured by the same piece of real estate (albeit with different interests therein).

The landlord, while presumably committed to allowing the tenant to obtain financing for the construction of tenant's improvements (and subsequent refinancings thereof),[3] will wish to ensure that the tenant and its lender remain subject to the lease and obtain no greater rights beyond the four corners of the lease that can otherwise impact the landlord or compromise its right (or that of a fee mortgagee should it become the landlord following exercise of remedies) to the rental stream under the lease and the residual fee interest. To that end, landlords may seek to expressly provide in the ground lease that any leasehold financing is subordinate to the lease and to any fee mortgage thereof.

For a leasehold lender, such a provision is anathema. It would enable the landlord's fee mortgagee, if it were to foreclose upon landlord's fee interest following the landlord's default under the fee mortgage loan, to contemporaneously foreclose on and wipe out the tenant's leasehold interest and any corresponding leasehold financing. Assuredly, this is an unacceptable result for the leasehold lender. And, in fact, from the perspective of the leasehold lender, for so long as the tenant (and by extension the leasehold lender) is not in default under the lease, the leasehold lender's interest must at all times remain paramount to the interest of the fee mortgagee. Accordingly, for the leasehold lender, optimally, the ground lease will provide that the fee mortgagee's interest remains subject in all cases to the ground lease.

Truth be told, the landlord and its fee lender ought to accept the leasehold lender's position and allow the fee lender to be subject to the ground lease, provided it was made absolutely clear that such subjection stops at the edge of the ground lease, and that under no circumstances does such subjection provide the leasehold lender with the ability to impair the right of the landlord or its lender (as applicable) to terminate the lease in the event of the tenant's default thereunder (following sufficient notice and cure rights afforded to the leasehold lender) or otherwise affect their rights, respectively, in the residual fee interest. Indeed, the correct result, it would seem, is for both the leasehold lender and the fee lender to obtain no advantage over the other, and for each, should it foreclose, to land in the same position that its respective mortgagor would be under the lease absent having entered into any such financings.

Unfortunately, however, many existing ground leases, both in New York City and elsewhere,[4] do not treat priority issues in this fashion. Rather, many ground leases, particularly the older ones, subordinate the lease to the fee lender's financing and attempt to solve the leasehold lender's problem via an SNDA (i.e., a separately made "subordination, non-disturbance and attornment agreement" among landlord, tenant and fee lender), which ordinarily provides, in essence, that, notwithstanding that the lease is subordinated to the fee lender's mortgage, for so long as the tenant (and by extension the leasehold lender if acting on behalf of the tenant) is not in default under the ground lease, the fee lender will recognize the tenant and its leasehold interest pursuant to the lease following a foreclosure of the landlord's fee interest.

The problem with the SNDA solution, however, is that an SNDA is an executory contract, and may be rejected under Section 365 of the Bankruptcy Code by the fee lender in the case of its own bankruptcy. Should this occur, the fee lender could then free itself of the obligation to recognize the tenant under the SNDA, but still foreclose under the fee mortgage and wipe out the leasehold lender's position. While seemingly a far-fetched scenario, particularly if the fee lender is a significant institutional lender (this would require a sequence of events such that, among other things, the landlord will have defaulted under its fee loan and the fee lender is separately in bankruptcy; though in truth such a scenario may not be difficult to envision given events following the Great Recession of 2008 and its aftermath), lenders, particularly commercial mortgage-backed securities lenders, view this as a significant flaw. Moody's, in published guidance for CMBS issuances,[5] takes the position that an "SNDA does not sufficiently mitigate the risks inherent when fee financing is superior to the lease and leasehold mortgage" because the SNDA may be deemed an executory contract that could be rejected in the fee lender's bankruptcy or may be declared unenforceable upon the fee lender's insolvency and takeover by the FDIC under 12 U.S.C. § 1823(e).6 While this issue can be addressed when entering into a new lease by subjecting any current or future fee mortgage to the lease in the manner noted above, using the SNDA mechanism with a refinanced leasehold secured by an existing ground lease may raise concerns with lenders, particularly in the case of CMBS originations.

A possible way out of the problem is to obtain the fee lender's agreement in an SNDA that if it fails to abide by the terms of its agreement to recognize the tenant or otherwise seeks to terminate the lease in violation of its agreement not to join the tenant in a fee foreclosure, then any subordination to such lender's mortgage is automatically terminated and the lease is deemed superior to the lien of the mortgage. Of course, such agreement itself may be deemed executory and possibly rejected, so this will not fully resolve the issue.

Triple Net Leases

To be clear, the issue described above not only affects ground leases, but also arises in just about any case of a triple net lease. A ground lease is really just a specialized form of triple-net lease, which is a form of lease agreement where the tenant is responsible to maintain and operate the property and pay all expenses thereof, including real estate taxes, utilities, insurance and maintenance, in addition to paying the rent, leaving the landlord in an essentially passive position such that it basically just collects the rent. Whereas ground leases are often used as a tool to develop or improve raw or underdeveloped land, triple net leases, which abound as investment instruments, are extensively used as a means of leasing just about any property class. Tenants under triple net leases are often investment-grade, and may include players from a variety of sectors including retail, pharmacy, banks, restaurants, warehouses and just about any other asset class, including operators of more complex, management-intensive uses involving hotels, casino/gaming operations, health care facilities and other types of property, while the landlords

(particularly when dealing with investment-grade tenants) can be REITs, insurance companies, pension funds and myriad other types of investors.

As with the ground lease, in a triple net lease the tenant may seek to finance its position with a leasehold mortgage financing while the landlord may also seek to secure fee mortgage financing, resulting in the similar question posed under the ground lease — that is, how to address priority as between the two separate financings that affect a single piece of real estate? It would seem that the appropriate approach here too would be for the landlord and its fee lender to allow for the fee mortgage to be subject to the ground lease, with appropriate clarifications, similar to those described above, to avoid impairing the landlord's or fee lender's position as provided under the lease. It should be noted that such an approach is generally more easily implemented in leases in which the landlord's interest is truly passive, whereas the less passive the landlord's interest, the harder it is to reach this result. Further, in triple net leases that involve complex opco-propco structures and/or where the underlying property operated by the tenant that supports the landlord's rental stream is very management-intensive, the resolution of this question can be far more complex, but such circumstances are outside the scope of this note.

Conclusion

The bottom line: When crafting a ground lease or any other form of triple net lease (and when investing in any such instrument), special attention should be given to the tensions that arise as a result of both tenant and landlord potentially seeking to finance their respective positions, and, in particular, the relative priorities of the leasehold financing and the fee financing. In ground leases involving construction or other development projects in particular, given there is usually significant upfront tenant investment, the tenant's leasehold financing may need particular deference when crafting applicable priority and subordination language. The refinancing of existing leases that run afoul of the rating agency guidance on this topic and do not adequately provide for the fee mortgage to be subordinated to the lease may need special attention to assuage lender concerns over financeability.

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[1] Moody's Investor Service, The Top Two Ground Lease Financing Flaws: Deficient "New Lease" Clauses and Superior Fee Mortgages, Jan. 6, 2016.

[2] The desire to retain residual ownership is often found in the case of religious, educational and governmental institutions. In fact, in New York City, for example, some of the largest landowners (both currently and historically) include such parties. (See Aleksey Bilogur, Who Are the Biggest Landowners in New York City?, May 27, 2016, http://www.residentmar.io/2016/05/27/biggest-landowners-nyc.html.) Ground leases made by such landowners, as well as various families with interests in large swaths of New York City real estate, among others, are an ever-present feature of New York City real estate.

[3] Indeed, tenant's financing, which enables the tenant to construct improvements or otherwise develop the leased property and thereby to subsequently monetize the fully constructed/developed asset and pay the required rental under the lease to the landlord, is indirectly the essential means by which the landlord ultimately derives value from the property; consequently, the landlord is incented to

ensure the tenant’s ability to secure such financing and subsequently refinance the same for the duration of the lease term.

[4] Given the lengthy duration of many ground leases, many older New York City ground leases, covering significant properties and first implemented in the 1980s and prior, remain in effect. Such leases predate many of the sophisticated lending practices currently in effect, that have been promulgated in connection with CMBS issuances and other lending practices of more recent vintage.

[5] Moody’s Investor Service, The Top Two Ground Lease Financing Flaws: Deficient “New Lease” Clauses and Superior Fee Mortgages, Jan. 6, 2016.

[6] See, e.g., Kimzey Wash, LLC v. LG Auto Laundry, LP, 418 S.W.3d 291, Tex. Court of Appeals, 5th Dist. 2013, cited in the Moody’s article cited above, which uses 12 U.S.C. § 1823(e) and the D’Oench, Duhme doctrine to declare unenforceable an SNDA made by a fee lender subsequently taken over by the FDIC. The FDIC transferred such lender’s assets to a different bank, which consummated a foreclosure of the applicable mortgage and effectively wiped out the leasehold interest purportedly protected by the SNDA.