2-06 UNSUBORDINATED GROUND LEASES
GROUND LEASES AND LAND ACQUISITION CONTRACTS
-- By Emanuel B. Halper

§ 2.06 Transfer of Interest

[1]—Assignment

I can't say that I'm fond of assignment restrictions in any lease. However, I can certainly understand the need for the owner of an apartment house to exclude unstable, insolvent and psychotic occupants. Surely, a shopping center owner has a legitimate interest in knowing that creative and honorable merchants conduct business in his stores.

What I can't understand is why so many landowners try to restrict or limit a tenant-developer's right to assign his leasehold estate. After all, the tenant of a ground lease that contemplates extensive construction is bound to invest a fortune of money in somebody else's land. Some day, the leasehold improvements will revert to the landlord, but we think of the reversion as a remote event that will be significant only to the grandchildren of the landlord and tenant. Meanwhile, a ground lease tenant-developer legitimately expects to reap the fruits of his investment and to share his good fortune modestly with the landlord by paying ground rent.

Now comes trouble, and the tenant-developer finds that he can't pay off his mortgage lender. If the only security for a debt is a leasehold estate derived from an unsubordinated ground lease, the lender can't expect to take the land and buildings and sell *them* to recoup its investment. What it can expect to take is the tenant's leasehold estate. But how can the lender take the leasehold estate if the ground lease provides that the leasehold estate can't be assigned without the landlord's consent?

Clearly, a right of assignment should be considered a routine courtesy in the case of an unsubordinated ground lease. A ground lease tenant has no other way of selling the buildings and other improvements it constructs. The landlord has nothing to lose by agreeing to permit assignment. Because an unsubordinated ground lease landlord doesn't execute the leasehold mortgage, he keeps his land even in the event of a default by the tenant-assignor or the tenant-assignee under the leasehold mortgage.

Nevertheless, ground leases contain many varieties of restrictions on assignment. One such restriction, a restriction against assignment before construction of the project, *is* justified. Because of the

exculpation clause (which limits the tenant's liability under the lease to the leasehold estate itself), the landowner has no significant recourse in case the tenant starts building the project and never finishes. Knowing that his original tenant (with whom he has developed a measure of personal rapport) will stick with the project until the original building is completed should provide a degree of comfort to the landowner.

Some ground lease *experts* advocate that it's okay to prohibit the tenant-developer from *assigning* the leasehold estate during the entire term of the ground lease as long as he is specifically permitted to *mortgage* the leasehold estate.

I'm not impressed.

The concept is troublesome. Assume that a mortgage of the leasehold estate is permitted but that assignment is prohibited. From the point of view of an institutional lender asked to lend against the security of a leasehold estate, a ground lease that permits the tenant-developer to mortgage the leasehold estate but prohibits assignment is not really satisfactory. True, the mortgage itself won't be a default under the lease, but of what use will the mortgage be if the tenant-borrower-developer fails to pay the mortgage debt? At that point, the mortgagee will need the right to foreclose the mortgage which, in the context of a leasehold mortgage, means to require that the leasehold estate be assigned to the lender. If the ground lease prohibits assignment, the mortgagee might not even have the right to acquire the leasehold estate as a result of foreclosing on its mortgage.

Even if the mortgagee has the power to succeed to the ownership of the leasehold estate itself but not the power to sell the leasehold estate to the highest bidder, the security of a mortgage of that kind of leasehold estate would be less than completely desirable.

Take a step further. Suppose the ground lease actually permits the tenant to mortgage the leasehold estate and also permits the leasehold estate to be assigned to the mortgagee or to another person as a result of foreclosure proceedings. Suppose also that the lease prohibits any other assignment. Have we created an instrument that will stimulate happy feelings in the heart of a lawyer reviewing the lease on behalf of an institutional lender? No. You won't have made his day pleasant at all. Although, this mortgagee is clearly in a position to acquire the leasehold estate and to sell it to the highest bidder, who's going to pay serious money for a leasehold that can't be resold without the landlord's permission?

Why then can't the lease prohibit assignment without the landlord's consent as long as the landlord agrees not to withhold consent unreasonably. This formulation doesn't work either. It doesn't work because the question whether an assignment is permissible will always be in doubt until the landlord actually consents or a court adjudicates the question whether consent will have been withheld unreasonably.

If the landlord has the power to refuse consent, a tenant-developer who wants to sell his leasehold estate must go through the fuss and bother of finding a purchaser-assignee, making a deal with him, and gathering information to submit to the landowner before he will know whether he has the right to consummate the deal. Moreover, a prospective purchaser must also spend a great deal of time, money and emotion in studying the economics of the project and negotiating with the seller before he can find out whether the seller has the right to sell. The prospect of going through all of this trouble for nothing will inhibit many investors from negotiating for the purchase and will thin the ranks of prospective purchasers.

Institutional mortgagees recoil at the prospect of being required to ask a landlord for consent to assignment of a leasehold estate. To begin with, there's an emotional barrier. A financial institution is usually the one to which requests are made—not the one making requests. Even without the emotional barrier, a right to assign that depends on the landlord being reasonable should not appeal to a prospective leasehold mortgage lender. The institution would need the landlord's consent to foreclose its mortgage and to sell the land to a bidder at the foreclosure date.

Even if the landowner were completely civilized, honorable, religious, and devoid of human greed, his right to refuse consent to assignment reasonably could kill almost any prospective assignment and could be a nuisance. The tenant's remedy for a landlord's unreasonable refusal to consent to assignment is a lawsuit to enforce the landlord's obligation to be reasonable. Lawsuits take time. In fact, they take so much time that almost any prospective sale of the tenant's leasehold estate will die of old age before the case is tried. A victory in the lawsuit and damages awarded by a court might soothe the pain a bit, but it won't get the property sold.

The necessity of relying on a lawsuit to discover whether the landlord is or isn't required to consent to assignment makes it impractical for a leasehold mortgagee to conduct a foreclosure sale.

Should a leasehold mortgagee be expected to bring a lawsuit to determine whether the landlord can refuse consent reasonably with respect to every potential bidder? What miracle will keep all of the bidders continuously interested in the property during the pendancy of the lawsuits?

Since a leasehold mortgagee can never acquire more than the leasehold estate as a result of foreclosure, it has every good reason to demand that it have at least the right to acquire the leasehold estate in case of a default by the tenant-borrower, to sell what it will have acquired to anyone willing to pay for it, and to represent to all prospective buyers that anyone who buys the leasehold estate will be free to resell it in the open market.

[2]—Subletting

Another mechanical reaction I find popular among real estate lawyers is to prohibit subletting in all leases. I'll concede that the idea can be fair (or unfair) in the context of an apartment lease, store lease, office lease, theater lease, bank lease, or restaurant lease.

But in a ground lease? Well, even in a ground lease, if the intended use of the land is farming, access to an adjacent building or parking for a building in the neighborhood, a restriction on subletting might be understandable. However, these are exceptions to the general principle.

When the tenant of an unsubordinated ground lease expects to develop an office building, shopping center, apartment house or hotel on the leased land, a prohibition against subletting is preposterous and makes the lease unmortgageable.

Subletting is the life blood of a project developed on leased land. If a tenant-developer can't sublet the buildings he constructs on the land, who will provide the income stream to pay ground rent, real estate taxes and operating expenses and to discharge the mortgage debt?

In some ground leases, subletting isn't restricted, but a security interest in the subleases and the income stream expected to be derived from the subleases is granted to the landowner. Many landowners feel they have good reason to ask for a security interest in the subrents and the subleases; most likely, the tenant-developer will have refused to deposit any security with the landowner at all.

Although such a proposal may seem just from the landowner's point of view, this type of arrangement is potentially dangerous. The leasehold mortgagee usually advances all or almost all of the funds needed to develop the land and does so principally in reliance upon the income stream that is expected as a result of the development. Of course, the subleases are the underlying foundation of the income stream. Accordingly, the landowner and the holder of an unsubordinated leasehold mortgage both seek nourishment from the same chicken, and there might not be enough meat to satisfy the hunger of both. Clearly, the leasehold mortgagee must have the right to eat first. If a second leasehold mortgage is contemplated, the second mortgagee will demand second place.

A landowner can get away with demanding a security interest in the income stream as long as it is clearly subordinate to the security interest of the leasehold mortgagees.

[3]—Priority of Lien

[a]—The Need for Priority.

An unsubordinated ground lease should be the first lien against the fee simple (ownership) estate.

This principle is important because of practical considerations, legal requirements, and institutional policy.

If the land is encumbered by a mortgage (a fee mortgage) that is paramount to the lien of the ground lease, a foreclosure of the fee mortgage could provoke the defeasance of the leasehold estate. This would spell disaster for the ground lease tenant (the developer) and the leasehold mortgagee. Without ever being in default under the ground lease, the tenant-developer and the leasehold mortgagee would lose everything.

Investment laws that govern many institutional lenders prohibit or limit loans secured by second[1] and other subordinate mortgages[2]

A mortgage of a leasehold estate which is, in turn, subordinate to a mortgage of the fee simple (ownership) estate seems like a second mortgage to me. Even lenders who don't have to answer to regulators aren't likely to jump to lend against the security of a mortgage of a

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[1] N.Y. Ins. L. § 1404(a)(6)(A)(ii).

[2] Mass. Gen. L. Ann., Ch. 175, § 63.7B.

leasehold estate that is subordinate to a fee mortgage. Most will reject the idea without giving it much thought because of long-standing corporate policies.

[b]—Verifying the Order of Priority.

The question whether the lien of a ground lease is paramount or subordinate to the lien of a mortgage is generally governed initially by the order of recording.[3] Consequently, unless the order of priority is changed by the lienors, a ground lease recorded before a fee mortgage is paramount in lien to the fee mortgage, and a fee mortgage recorded before a ground lease is paramount in lien to the ground lease.

Because a leasehold estate that is subordinate to the lien of a fee mortgage is usually not very interesting to a potential leasehold mortgagee, the negotiators for a ground lessee should exercise great care in determining whether the land is already subject to a mortgage at the time the lease is executed.

A simple step to take in this direction is for the ground lessee's negotiators to insist that the landlord represent that the landlord's title to the land is free and clear of all mortgages and, for that matter, all other burdensome liens and encumbrances.

If the landlord's estate in the land is subject to any mortgage, lien or encumbrance, the representations clause should indicate that it is. In addition, the clause should identify the mortgage, lien or encumbrance. It should state that the landlord is not in default, breach or violation under the mortgage, lien or encumbrance and that the debt secured by any mortgage has not been accelerated.

I wouldn't stop there. Although landowners seldom misrepresent the status of their title, tenant-developers have too much at stake to rely entirely on the representations of landowners. The landowner's title should be searched, and the tenant should buy title insurance that guarantees that the tenant's leasehold estate constitutes a first lien against the fee (ownership) estate and that the lien of the

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[3] See, e.g., N.Y. Real Prop. L. § 291. Recording officers are required to enter the hour, day, month and year that an instrument is recorded in the official record book. See N.Y. Real Prop. L. § 319. Similarly, in Massachusetts, the purpose of the recording statutes is to protect subsequent purchasers against *prior and unrecorded* conveyances of which they have no notice. See Mass. Gen. L. Ann., Ch. 183, § 4, Ch. 36, §§ 15 and 26.

leasehold estate is not subject to the lien of a fee mortgage. The amount of the title insurance coverage to be carried should take the entire cost of development into account.

[c]—Changing the Order of Priority.

The fact that the fee simple (ownership) estate in the land is mortgaged before the recording of the ground lease is not necessarily fatal to the interests of a tenant-developer.

The order of priority can be changed by agreement among the landlord, tenant, and fee mortgagee. To this end, the landowner can agree that, although his title may be subject to the lien of a mortgage recorded before the execution of the lease, the landowner will undertake to convince the holder of the fee mortgage to agree to subordinate the lien of the fee mortgage to the lien of the ground lease.

This is the essential subject matter of the *subordination* clause of an *unsubordinated* ground lease.

Why put a subordination clause in an unsubordinated ground lease?

Before I answer that question, let me try to clear up some confusion.

Subordination clauses of ground leases confuse (and sometimes fuse) two entirely different concepts. Many ground leases (inaccurately) believe that "subordination" is a requirement that the landlord execute a mortgage of his land as additional security for a loan made to the tenant (developer) and used to pay for the construction of buildings and other improvements on the land. Although the reference is inaccurate, it has become used so widely that almost everyone in the business who deals with ground leases refers to a ground lease that requires a landlord to mortgage his land as a "subordinated ground lease."

In its true sense, however, a subordination clause deals with the priority of various liens against the fee simple or ownership estate. A lease is such a lien; so is a mortgage of the fee simple estate. A clause that requires one lienor to subordinate its lien against the fee simple estate to the lien of another lienor is a true subordination clause.

The subordination (true subordination) clause of an unsubordinated ground lease should require the landowner to induce

any fee mortgagee to subordinate the lien of its mortgage to the lien of the ground lease. The clause should also provide that, if the lien of the fee mortgage is not subordinated within a fixed period of time, the landowner will discharge the mortgage.

This is all very different from the standard formula we find in department store and office leases. Lawyers whose experience in leasing transactions is limited to occupancy leases are in the habit of requiring the tenant to subordinate the lien of the leasehold estate that arises pursuant to an occupancy lease to the lien of one or more mortgages of the fee simple estate. This habit can be dangerous to a lawyer if he is suddenly confronted with a ground lease negotiation and is not able to understand the fundamentally different needs of parties to ground leases.

The blind adaptation of clauses from occupancy leases to ground leases has resulted in some ground lease clauses that require the tenant to subordinate the lien of the leasehold estate to the lien of mortgages of the fee simple estate rather than the other way around.

Such clauses are usually moronic. A ground lease tenant who intends to develop a large office building, hotel, shopping center, or apartment complex would find few sane lenders willing to put up the money if he were burdened by such a provision.

Occasionally a ground lease requirement that a tenant subordinate the lien of its leasehold estate to the lien of a mortgage of the fee simple estate is appropriate.

Here’s an example. In the 1970’s, fast food restaurants and banks rushed to find space in community type shopping centers. Ideal sites were available—one acre parcels near the front entrances of the shopping center. These sites were available because the prevailing design theory for community type (60,000-200,000 square feet of retail space) shopping centers in the 1960s and 1970s was to build the stores a considerable distance from the highway frontage. The distance between the highway and the stores allowed customers to park automobiles in front of the stores. That was an attractive arrangement because the part of a community type shopping center that lies between the rear of the stores and the rear of the shopping center parcel is dirty, mysterious, and a bit dangerous. Customers don’t like to park there at all.

In any event, the result of this policy was to leave a large paved area between the stores and the highway open. Since shoppers don’t like to walk, the most frequently used part of this open paved area

was the part closest to the stores (and farthest from the highway frontage). This left (perhaps the most potentially valuable) part of many shopping centers (the part near the highway) undeveloped and largely unused. Fast food operators and bankers loved the sites. They were perfect.

Parcels of land containing between one-half acre and approximately two acres were carved out from numerous shopping centers and leased to restaurant and bank operators.

The carved-out parcels were parts of integrated shopping centers. Accordingly, the owners of the shopping center expected fully to mortgage the carve-outs with the balance of the shopping center.

Fortunately for the shopping center owners, neither the restaurant operators nor the bankers expected to finance the extensive improvements they made to the carved-out parcels with institutional mortgage loans. They used their own funds or raised what they needed in sale-leaseback transactions. Consequently, it was not necessary for the ground lease tenants of the carved-out parcels to have mortgageable ground leases.

Many ground leases of this variety followed the general pattern of occupancy leases and required the tenant to subordinate the lien of its leasehold estate to the lien of a fee simple mortgage. Of course, in this circumstance, the loan secured by the mortgage of the fee simple estate provided most of the funds needed to develop the main section of the shopping center. That loan, in turn, made the land that was carved out and leased to the restaurant operator or bank very valuable indeed and provided the rationale for the otherwise bizarre requirement that the lien of the fee mortgage be paramount to the lien of the ground lease.

Let’s return to conventional unsubordinated ground lease tenants and their need for the ground lease to be paramount to any mortgage of the landowner’s fee simple estate.

Although tenant-developers are principally concerned with the possibility that a fee mortgage would be paramount in lien to the ground lease at the time the ground lease is recorded, it is also possible for a fee mortgage executed after the recording of the ground lease to present difficulties. If a landowner mortgages his land after the original ground lease is recorded but before the execution of any new ground lease executed pursuant to the *new lease provision* of a ground lease, the lien of the fee mortgage would

be paramount to the lien of the lease executed pursuant to the *new lease provision* (unless additional precautions are taken).

Typically, a *new lease provision* requires the landowner to execute a new lease of the land with the leasehold mortgagee (as tenant) in case of a termination of the original ground lease.[4]

The termination of the original ground lease would, of course, extinguish the lien of the original leasehold estate, and the new lease would create a new leasehold estate. Unless a fee mortgage or other intervening lien encumbers the property when the new lease is recorded, the leasehold mortgagee would have the benefit of its bargain and would have no cause to complain.

However, what happens if the landowner's fee simple estate is encumbered by a subordinate fee mortgage at the time the original lease is canceled and the new lease is executed? Unless the subordinate fee mortgagee has agreed to the contrary, the fee mortgage would skip to the head of the line and would be paramount to the lien of the leasehold estate arising from the execution of a new ground lease. Of course, if the lien of the fee mortgage is paramount to the lien of the leasehold estate arising from the new ground lease and the fee mortgage is later foreclosed, the leasehold estate arising from the new lease would be subject to defeasance.

To avoid these problems, a tenant negotiating an unsubordinated ground lease should also require a present or future mortgagee of the fee simple estate to subordinate the lien of the mortgage to the lien of any future leases executed pursuant to the new lease provision of the ground lease.

[4]—The Estate of the Landlord

Most of the time, the estate of the landlord under a ground lease is a fee simple estate. On rare occasions, you'll be involved with what you think is a ground lease deal only to discover that the landlord doesn't own the land at all and his estate in the land is a leasehold estate. That would mean that you would really be working on a ground sublease.

Relatively few developers are interested in *subleasing* a parcel of land and then investing millions of dollars in developing the land. They don't like to invest in a subleasehold estate because the

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[4] See § 2.07[5] *infra* for a detailed discussion of the new lease clause.

termination of the paramount lease as a result of a default by the lessee under the paramount lease would also result in the termination of the subleasehold estate.

However, there are circumstances under which a subleasehold estate can be desirable and mortgageable.

Let's assume that a landowner, Max, leases his land to his nephew, Sheldon. Sheldon was a rock musician until he was twenty-eight when his only album, "Sounds of Cucumbers and Crocodiles," set an all time record for dismal sales. Discouraged by his lack of success in his chosen profession, he turned to real estate (as so many others have done since the beginning of time). After buying and selling a few apartment buildings at a profit, he convinced his mother and uncle that he was a genius. In the midst of all the euphoric feelings, he leased his uncle's land for a term of 100 years but did nothing to develop it for the next five years.

Unexpectedly, he meets Jerome, a forty-three year old developer with a long and distinguished record of developing office parks. After a while, Sheldon agrees to sublet the land to Jerome. Can the sublease be mortgageable under any circumstances?

One way to make the subleasehold estate mortgageable would be to provide that the fee owner (Max) would not have the right to terminate the paramount ground lease pursuant to the provisions of the ground lease or pursuant to any statute or other law. Another way to deal with this problem is to provide that both Sheldon (the tenant under the paramount ground lease and sublandlord under the sublease) and Jerome (the subtenant) execute the subleasehold mortgage. As a result the mortgage would encumber the leasehold estate as well as the subleasehold estate. Otherwise, Jerome (the subtenant) should forget about the deal.

If a tenant-developer wants to find out if a landowner actually owns or leases his land, the first step to take is to ask that he represent the source of his estate in the land.

In the unlikely event that he represents that his estate is a leasehold estate and the developer is willing to cope with the circumstances, he should ask to see the paramount ground lease. If the paramount ground lease doesn't make sense, he should kill the deal and look for something else to do with his spare time. However, if the paramount ground lease looks good and the prospective subtenant wants to play the game, he should ask the sublandlord to represent that the copies of the paramount ground lease that were

exhibited to the subtenant are accurate and complete; that the paramount ground lease is in full force and effect; that it hasn't been modified, supplemented or amended; and that the sublandlord isn't in default, breach or violation (in its capacity as tenant) under the paramount ground lease.

Of course, the paramount ground lease may have been amended, modified or supplemented. In that case, the amendment, modification or supplement should be identified. If any information about a default, breach or violation emerges, the nature and extent of the default, breach or violation should be described.

The sublandlord should also be required to represent whether his leasehold estate or the landowner's fee simple (ownership) estate are subject to any mortgage, lien, or other encumbrance.

If the sublandlord's leasehold estate or the landowner's fee simple estate are encumbered by a mortgage or any other lien or encumbrance, the sublandlord should be required to deliver accurate and complete copies of the mortgage or other instrument of lien or encumbrance. The representations clause should require the sublandlord to represent that the copies are accurate and complete; that none of the instruments have been amended, modified or supplemented; that the sublandlord is not in default with respect to any leasehold mortgage or other lien against the leasehold estate; that the landowner is not in default, breach or violation with respect to any mortgage or lien against the fee simple (ownership) estate; and that the debt secured by any mortgage of the fee or leasehold estates has not been accelerated.

Here too, the representations of a landlord (or sublandlord) are not enough. A prudent developer should insist on having the title searched and buy title insurance so that he'll have a creditworthy source of compensation in case he is misinformed.

[5]—Estoppel Certificates

An estoppel certificate clause requires the parties to a lease to execute a document that provides assurances to third parties as to the validity of the lease and the status of the parties of the lease.

Whenever a leasehold estate is assigned or mortgaged, the assignee or mortgagee may be expected to insist upon having a copy of the lease and verifying that its copy of the lease is accurate and complete. Many sublessees will demand assurances in this respect

also. The purchaser of a fee simple (ownership) estate that is subject to the lien of a ground lease has a similar urgent need to know the exact contents of the lease.

Accordingly, the estoppel certificate clause should require both the landlord and the tenant to execute a certificate that identifies the lease and specifies whether the lease has been amended, modified or supplemented. An accurate and complete copy of the lease and all modifications or supplements should be required to be attached to the estoppel certificate, and the certificate should state that the copy is accurate and complete.

An estoppel certificate should also state whether the lease is in full force and effect. If the person executing the certificate says that it isn't, he should also say why it isn't.

In addition, the clause should deal with the question whether the party executing the certificate contends that the other party is in default, breach or violation. Of course, if a party contends that the other party is in default, breach or violation, it should explain its contentions.

Finally, the estoppel certificate clause should require the party executing the certificate to specify the date through which rent and other charges have been paid.

[6]—Anti-Merger

Some lawyers who represent institutional mortgage lenders are concerned about an ancient common law doctrine, the doctrine of merger. The theory of the doctrine is that, if a single party becomes the owner of both the fee simple and leasehold estates in a given premises, the fee and the lease would merge and accordingly, the leasehold estate would magically disappear. If the leasehold estate would disappear, the leasehold mortgage might disappear with it and so might the executives who made it possible for the institution to lose its sole security for a large loan.

Consequently, some ground leases anticipate this concern and provide that, as long as any mortgage encumbers the leasehold estate, the leasehold and the fee will not merge even if the tenant acquires the fee simple (ownership) estate.