§ 2.07 Default, Termination and Dispute Resolution

[1]—Termination as a Result of a Default

The bane of every lender asked to lend against the security of an unsubordinated ground lease is the possibility that the tenant-borrower will fail to comply with one or more provisions of the ground lease and that the ground lease will be terminated. If the ground lease is terminated, the leasehold mortgage will be a lien against nothing, and the lender’s investment will be irretrievably lost. To make an unsubordinated ground lease mortgageable, you’ve got some work to do in the default clause of the lease.

One simple and effective way for a tenant to deal with the issue is not to grant a right of termination to the landlord as a result of a default in the first place. Why should a developer and leasehold mortgagee be asked to forfeit millions of dollars of invested capital because one rent payment is late or because the roof of a building (constructed by the tenant with the leasehold mortgagee’s money) leaks? The landlord can have other effective remedies to deter breaches on the part of the tenant.

Discarding the concept of termination altogether would geometrically reduce the chance that a mortgage lender would find the ground lease to be unmortgageable. I’ve seen more than one prospective mortgagee back away from a ground lease after it agreed in principle to lend against the leasehold estate. Most of the time, it happened because the prospective mortgagee felt that it had insufficient protection against the possibility of termination.

From the landowner’s point of view, termination is useful because it can be used to intimidate the tenant. But is it essential? I think not. Other remedies can be combined to function as a just substitute for termination and an effective way to deter the tenant from defaulting with respect to his obligations under the ground lease.

In the 1980s, the idea that a lease might not be terminable by the landlord in the event of a tenant default may seem strange—even radical. After all, almost every lease that’s been executed in the latter half of the twentieth century has a termination clause.

Of course, these leases include occupancy leases for apartments, offices, factories, warehouses, stores, theaters, and restaurants as well as ground leases. And almost every lawyer who is called upon to
negotiate a ground lease has negotiated an occupancy lease first. As intelligent and thoughtful as most lawyers must be to get through law school and pass a bar exam, relatively few of them have utilized enough of their intellectual resources to be able to distinguish the essence of an occupancy lease from the essence of a ground lease. They know that, unless the landlord of an occupancy lease has the ultimate remedy of evicting the tenant, the tenant may choose not to comply with his obligations under the lease. They surmise that this is also the case when it comes to a ground lease. It is not the case.

Tenant-occupants conduct business from premises constructed at the expense of their landlords. Ground lease tenant-developers construct buildings and other leasehold improvements at their own expense and borrow the funds to pay for the leasehold improvements from financial institutions. The landowner invests virtually no funds, time or effort.

The tenant-developer in the ground lease relationship is also the borrower-developer in the leasehold mortgage relationship, and the mortgage instrument governing the relationship between the leasehold mortgage lender and the tenant-developer usually contains covenants that are parallel to the ground lease covenants. Consequently, a tenant-borrower-developer who fails to comply with the covenants of the ground lease also risks offending his mortgagee (which usually is a very self-destructive thing to do). The tenant-borrower-developer’s need to avoid defaulting under the leasehold mortgage also deters him from defaulting under the ground lease.

A ground lease landlord who can’t terminate the ground lease can, nevertheless, also deter noncompliance with such valuable tools as late charges, the right of self-help, the right to appoint a receiver to sequester the income from the project and apply it to carrying charges, and the right to specifically enforce compliance with the tenant’s covenants.

[2]—Traditional Methods of Coping with the Termination Remedy

Although eliminating the right of termination makes a great deal of sense in many ground lease situations, it is an unusual idea today. In the intellectual climate in which development oriented ground leases have been negotiated for most of the twentieth century, institutional mortgage lenders have become conditioned to accept the
right of termination as an unsettling reality with which they are willing to cope in the context of a suitable framework. That framework has been accepted by so many financial institutions that it is regarded by some as a customary way to comfort a leasehold mortgagee.

A leasehold mortgagee that is willing to tolerate a right of termination in the ground lease wants to know that it will get notice of every potential ground lease default of the tenant-developer, have the right to cure the potential default, and have a long enough time period in which to do so. A leasehold mortgagee also wants to know that, as a practical matter, the leasehold mortgagee will be able to cure any potential default that might arise and prevent termination of the leasehold estate. A leasehold mortgagee also wants to know that the lease cannot be terminated by a default that is not susceptible of being cured.

[a]—Notices.

Thus, if an unsubordinated ground lease is to have a termination clause and a tenant-developer still wants the ground lease to be mortgageable in the context of the traditional approach, he must be sure that the path that might lead to termination in the end can’t even start without notice to both the tenant-developer and the leasehold mortgagee.

A notice of a default that can result in termination of the leasehold estate should be valid only if mailed by certified mail or registered mail, return receipt requested. I’ve never been happy with clauses that provide for notice by private messenger service or process servers. I’ve heard too many stories about process servers who don’t try very hard to hand a summons to a defendant personally but who are quite willing to swear that they did. If mail service stops because of a U.S. Mail Service strike, notices delivered by a messenger service with an outstanding reputation for reliability such as Federal Express or Emery should be an acceptable substitute.\(^1\)

Just getting notice that a default has occurred is not enough. The lease should provide that the nature of the default should be specified in reasonable detail so that the tenant-borrower and the leasehold mortgagee will know exactly what the landlord’s allegations are. If

\(^1\) See § 2.08[1] infra for some additional ideas on notices.
the tenant doesn’t know what the landlord is complaining about, how can he be expected to cure the potential default?

[b]—The Tenant’s Right to Cure.

The next step is to make sure that the tenant-borrower and the leasehold mortgagee each have the right to cure the potential default.

The rights to cure should not run concurrently. Leasehold mortgagees don’t want to be drawn into routine encounters between landowners and tenants. Some landowners complain all of the time and give notice of default several times a year. A leasehold mortgagee should not be forced to deal with the possibility that the leasehold estate will be terminated every time a dispute arises between the landowner and the tenant. To avoid this possibility, a leasehold mortgagee should have the right to sit relaxedly on the sidelines until the tenant has had a fair opportunity to cure after notice and has failed to do so.

Therefore, the first step is a requirement that the landlord give notice to the tenant and that the tenant be in a position to cure the default within an appropriate period. If the tenant fails to make good within the cure period, the landlord should be permitted to take one step further and give notice of default to the leasehold mortgagee. Then, the leasehold mortgagee should get its chance to cure.

This sounds like a big burden for a landlord. Maybe it is, but when you weigh the pain a landlord might suffer by sending a few notices against the absurdity of a forfeiture by a tenant-developer and leasehold mortgagee of a multi-million dollar investment, justice and good sense clearly favor this procedure. To provide instant comfort for the landlord’s distress, the lease should require the tenant to pay a late charge and just compensation to the landlord for the time, expense and trouble of giving notice.

Just how long should the cure period be? That depends on the nature of the default. If the landlord is complaining that the tenant has failed to pay rent, insurance premiums or real estate taxes, a thirty day period beginning on the date on which the notice is actually delivered is about right.

For any other default that, as a practical matter, can be cured, the cure period is usually set initially at thirty days after the notice of default is actually delivered. However, that’s not the end of the story. For one reason or another, it may be impractical to even begin to
cure a nonmonetary default within thirty days. Suppose that the
default is a failure to make repairs and that the repairs can’t be made
until equipment or materials are delivered. Suppose also that the
customary delivery time for the equipment or materials is forty-five
days and that, once the equipment or materials arrive, it will be no
problem for the tenant to complete the repair within thirty days.
Under these circumstances, the cure period should start in forty-five
days and last for another thirty days.

On the other hand, it might be entirely feasible to begin the cure
promptly after the notice of default is received but not at all possible
to complete it within thirty days. The cure period should be extended
here too, and the extension should last as long as the tenant or the
mortgagee diligently prosecutes the cure.

We still haven’t completed the cycle. A tenant should be entitled
to further extensions in case its effort to cure a default (of course,
other than a default in the payment of money) is delayed as a result
of force majeure. Force majeure, a phrase adopted from the French,
means unusual catastrophic events that cause delay. These events
include fires; strikes, lockouts, and labor difficulties; riots, sabotage,
conflicts and war; government actions; materials shortages;
unusually inclement weather; and causes beyond the reasonable
control of a party.

The cure period should also be extended or further extended, as
the case may be, in case of a bona fide dispute about whether any
state of facts, alleged to be a default by the landlord, actually is a
default. Most landowners are content to collect their ground rent, to
live, and to let their tenants live. However, more than a handful of
landowners who have executed unsubordinated ground leases
envision the lovely possibility that the tenant will default and forfeit
(to the landowner) the millions of dollars worth of improvements
constructed at the tenant’s expense. To such people, it makes sense
to allege a new default upon the appearance of every new moon.

A ground lease tenant who is confronted by monthly default
notices from his landlord has little choice but to do what the landlord
demands unless the lease provides a way for the tenant to avoid this
problem. The way to avoid this problem is to grant the tenant an
opportunity to contest whether the landlord’s complaint has a just
foundation before the tenant is forced to decide whether to do
whatever the landlord is demanding or risk forfeiture of the leasehold
estate.
[c]—The Leasehold Mortgagee’s Right to Cure.

In addition to the extensions to which the tenant-borrower should be entitled, a leasehold mortgagee customarily insists upon additional rights to extend the cure period further.

First of all, leasehold mortgagees want the right to get a second notice of default and an opportunity to cure after the tenant’s cure period will have expired.

Secondly, some leasehold mortgagees don’t want to lay out the funds to cure a default unless the mortgagee is also able to acquire the leasehold estate, take possession of the premises, appoint a receiver, or do all three. To deal with these needs, an unsubordinated ground lease which is intended to be mortgageable should provide that the period in which a leasehold mortgagee may cure a default will be automatically further extended by the period in which the mortgagee forecloses the leasehold mortgage. The extension should be contingent on beginning the foreclosure proceedings promptly after the mortgagee receives notice of the default; it should continue as long as the leasehold mortgagee diligently prosecutes the proceedings. Similarly, the default clause should also provide for a further extension for any period in which the leasehold mortgagee brings appropriate legal proceedings to obtain possession of the premises or appoint a receiver as long as the proceedings are begun promptly after the notice is given and the proceedings are prosecuted diligently thereafter.

[d]—Defaults Which Cannot Be Cured.

Think for a moment. Who’s to say it’s possible to cure every default in a ground lease?

Suppose the tenant is prohibited from making loud noises on the land—perhaps for fear of reducing milk production on the landowner’s adjacent dairy farm. Then, in willful violation of the covenant, the tenant sponsors a wild rock party to celebrate the construction of a $100 million enclosed mall shopping center on the site. In an obvious display of refinement and good taste, the cows stop giving milk altogether and add to the cacophony by bellowing forth their most unpleasant moos. Although the new sounds are accepted with joy by the frolicking crowd, the farmer’s wife is really furious. At sunrise of the next day when peace has returned, she and her husband serve the tenant with a notice of default.
The tenant would like to cure the default. However, how can he undo what happened yesterday? The farmer maintains that a default has occurred; that it can’t be cured; that the lease has, in fact, been terminated; and moreover, that, as partial compensation for having had such a terrible experience, the couple now owns the shopping center free and clear of the leasehold mortgage.

There’s a horror story for you.

The moral is that, if you want an unsubordinated ground lease to be mortgageable, you should make it clear that the landowner can never have the power to terminate the lease as a result of a default that can’t be cured.

[3]—An Alternate Approach to the Termination Remedy

[a]—The Pitfalls of Termination

The vulnerability of a ground lease tenant-developer to the unconscionable loss of a multi-million dollar development as the result of a lease default leads me to the conclusion that the customary way with which ground lease negotiators deal with the termination remedy can be improved considerably.

Even in the case of an occupancy lease, termination is often too severe—especially when it results in the forfeiture of extensive leasehold improvements made by the tenant. If the tenant’s default isn’t altogether terrible, terminating his leasehold estate is like confiscating his car because he double parked it on a busy street. Confiscation will surely discourage a parking violation more effectively than a small fine. I suppose that electrocution would be still more effective.

In the case of an unsubordinated ground lease, termination is an incredibly harsh remedy that can be justified only in the most extreme circumstances. Imagine the termination of a ground lease of a 20,000 square foot parcel worth $15 million that supports a $150 million high rise office building. What sin of a tenant-developer who invested $150 million in someone else’s land could be so great as to justify the forfeiture of his entire investment? What social good will the landowner have done to reap such a harvest?

Even the acceleration of a mortgage debt and the foreclosure of a mortgage are mild and civilized remedies when compared to the termination of a leasehold estate. In foreclosure, the creditor is
allowed to collect the debt from the proceeds of a sale of the security. After the debt is collected and the creditor is made whole, the debtor keeps the balance of the proceeds of the sale (if any). A terminated subordinated ground lease tenant keeps nothing.

The termination remedy is not always the best solution for a landowner either. Many landowners are not looking for unjust windfalls and would be quite content if the tenant-developer would simply live up to his end of the bargain. Needless to say, not all developers are angels, and some of them try to cut corners and won’t comply with a ground lease covenant unless the landlord is prepared to go to court. If the only remedy in the landlord’s arsenal is the right to terminate, most landlords will tend to be lenient and hesitate to enforce their rights altogether.

Some state laws provide for automatic cure periods for tenants who pay their rent late, and even persistently late rent payers might escape any kind of discomfort at all if the only remedy specified by the lease is the right of termination.

Courts are in no hurry to terminate leasehold estates. They are bound by the judicial maxim “equity abhors forfeiture,”2 and well they should be.

Consequently, it’s in the interest of both the landlord and the tenant to provide for an alternative system of remedies designed to promote compliance by the tenant with its obligations under the lease without resort to the termination remedy.

Instead of relying solely on termination of the leasehold estate as the principal way to deter late rent payment, mismanagement of the project, and deterioration of the physical facilities, an unsubordinated ground lease should adopt alternative remedies to deal with tenant defaults. The alternative remedies should include late charges, self-help, reimbursement, receivership and specific performance. Termination should be reserved for the most extreme circumstances and after all else has failed. An intelligently concocted ground lease can satisfy the need of the landlord for absolutely prompt rent

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Missouri: Wilson v. Watt, 327 S.W.2d 841 (Mo. 1959).  
payments and the need of the tenant to have generous cure periods in which to avoid any possibility of termination. Providing for alternative effective remedies would avoid the futility of relying on the ultimate weapon of termination to induce prompt rent payments from reluctant and nervy tenant-developers and the incredible injustice of the forfeiture of the leasehold improvements as a result of relatively minor defaults.

[b]—Alternative Remedies for Monetary Defaults.

The first step is to separate rent paying obligations from the others. The basic bargain between a landowner and a ground lease tenant is to substitute the rent for the right to exploit the income potential of the land. Of all the obligations a landlord may seek to impose on a tenant-developer pursuant to an unsubordinated ground lease, the one that is most significant is the obligation to pay rent. If rent is paid, most landlords of unsubordinated ground leases are prepared to forgive almost anything else. However, if rent isn’t paid, most unsubordinated ground lease landlords are willing to forgive nothing.

The rent obligation itself is divided into three major categories.

One category, the most obvious, is a stipend that the landlord expects to keep without diminution by real estate taxes or any expenses of operating or maintaining the property. Let’s call that one “Basic Rent.”

The second category is the obligation to pay real estate taxes, and the third is the obligation to carry insurance. A ground lease tenant’s failure to pay real estate taxes can result in the forfeiture of the landlord’s property to the taxing authority. The possibility of a forfeiture of the landlord’s property justifies a more extreme remedy from the landlord’s point of view. A failure to carry liability insurance would expose the landlord to lawsuits (and judgments) of people who enter the premises. If the tenant doesn’t carry fire and other property insurance, it’s possible that the leasehold improvements will be destroyed without the redemptive medicine of insurance proceeds to pay for the repair or replacement of the damage. That’s a dismal prospect because the rental value of the leasehold improvements is the foundation for the income stream that supports the all important Basic Rent that the landlord gets and expects to keep.
The most effective method a landlord can use to induce prompt rent payment is a stiff late charge. I recommend that landlords who want a practical remedy to foster prompt payment by a tenant-developer bargain for a late charge of at least 5% (why not 10%) of the amount due in case a rent payment is more than 15 days late. If rent is as much as one month late, the late charge should be an amount equal to the overdue payment. (As a result, a tenant who pays rent as much as one month late and wants to avoid termination could do so but only if he pays an extra month’s rent to the landowner.) An even greater penalty could be imposed for payments that are as much as two months late, etc.

Late penalties should not depend on notice either. Although the penalty can amount to a lot of money, it is minor pain for a tenant-developer compared to the forfeiture that comes with a termination remedy. A late payment system like this makes it good business for a tenant-developer to pay his rent on time. Few well-balanced developers would risk a quick, sure, and stiff late payment for the privilege of holding onto his money a few days longer.

What does the tenant-developer want in exchange for his willingness to agree to such a tough late penalty? What he wants is an extra long cure period after notice and before the termination remedy may be exercised. A sixty day period after receipt of notice of default is not too long a cure period for the termination remedy as long as the lease also makes provision for stiff late penalties. Stiff late penalties should be more than sufficient to deter a pattern of persistent tardiness. If the tenant-developer has a lengthy cure period before any possibility of termination, a leasehold mortgagee is more likely to be confident that the leasehold estate will be safe from loss as a result of an error by the tenant-developer’s accounts payable department. Although a tenant-developer will suffer plenty as a result of a late penalty, a $150 million project won’t be lost because a $25,000 rent check wasn’t mailed on time.

The landlord can get additional protection against the expense of giving notices by negotiating for a clause that requires the tenant to reimburse the landlord for the expense including any legal fees the landlord might incur.

A tenant-developer might want even more protection against the forfeiture remedy. And why not? Forfeiture is barbaric punishment, and late penalties are effective deterrents. A tenant-developer should
ask for one additional bulwark to avoid the termination remedy. The lease might provide that the tenant is entitled to one last chance in case the rent default is still not cured before the end of the sixty day cure period after the notice of default is given. After all, the tenant-developer’s clerk or bookkeeper might still neglect to send the rent check even after a notice of default is received. Perhaps the notice of default will be misplaced. Perhaps the notice will arrive when the tenant’s chief executive is on vacation. To deal with these possibilities, it is entirely appropriate for a ground lease tenant to insist that the termination remedy be exercisable only after a second notice of default is received and the default is not cured during a second cure period. The second notice should be addressed to the tenant-developer’s chief executive officer in person, and the second cure period should be short—maybe fifteen days.

These cure periods should be subject to further extensions by a leasehold mortgagee in case the mortgagee needs additional time to complete foreclosure proceedings against the leasehold estate, obtain possession of the land and the leasehold improvements, or appoint a receiver.

[c]—Alternative Remedies for Nonrent Defaults.

Termination of the leasehold estate need not be a remedy for nonrent defaults. Rights of self-help and injunction should be sufficient defensive weapons for a landlord who wants to make sure that the leasehold improvements will be kept in good repair and that they will not be used as a house of prostitution.

An unsubordinated ground lease landlord has a legitimate interest in knowing that the leasehold improvements will be kept in reasonably good order and repair and in compliance with applicable legal requirements. The leasehold improvements are the source of the income stream from which the rent will be paid. However, a tenant-developer ought not be vulnerable to the complete loss of the leasehold estate (and all of the leasehold improvements as well) simply because a faucet on the tenth floor of a thirty story office building leaks.

The remedy of termination is also an inappropriate way to deal with the need for a major repair or replacement. There are other ways.
If a landowner is so concerned about the state of repair of the leasehold improvements constructed by the tenant-developer at the expense of the leasehold mortgagee, he can exercise the right of self-help. The right of self-help is the right to enter the leasehold improvements and make a necessary repair or replacement or comply with a legal requirement then being violated. A landlord who exercises this right would be entitled to reimbursement for the cost of making the repair or replacement or the cost of complying with the legal requirement as the case may be.

Moreover, it’s not necessary for the tenant’s failure to reimburse the landlord for the cost of the self-help remedy to be a prelude to the exercise of the termination remedy. The cost of reimbursement could become a lien against the leasehold estate instead. The lien might or might not be subordinate to the lien of the first leasehold mortgage. If the tenant doesn’t discharge the lien within a reasonable period, the landowner could then have the right to foreclose the lien against the leasehold estate. Although foreclosure would be unpleasant and even burdensome to the tenant-developer, the burden would be a lot easier to bear than termination. Foreclosure might result in a forced sale of the leasehold estate and the application of the proceeds to the tenant’s obligation to reimburse the landlord for the cost of exercising the self-help remedy. However, the balance of the proceeds would go to the tenant. In the case of termination, all would be forfeited.

A landlord who hesitates to exercise the self-help remedy despite a marked deterioration of the leasehold improvements might find comfort by petitioning the courts for the appointment of a receiver. The receiver, in turn, would collect rent from the occupancy subtenants and apply these funds to the needed repairs and replacements and to real estate taxes, insurance premiums, and operating expenses. The appointment of a receiver or trustee would not be a happy day for the tenant, but it’s not a calamity like forfeiture.

If a ground lease restricts the use of the leasehold improvements or prohibits a use that is unpalatable to the landowner (e.g., a house of prostitution) and the restriction is violated, the landlord can enforce it by an injunction or an order for specific performance. It makes much more sense for the landlord to have the right to stop the prohibited activity than to seize all of the leasehold improvements because the restriction was violated.
Bankruptcy clauses don’t belong in unsubordinated ground leases. Including a bankruptcy clause in an unsubordinated ground lease is like dropping a starving shark in a fish tank primarily intended for rare tropical specimens. If you put a shark in the tank on Tuesday, I would expect some material changes by Wednesday. Of course one logical (but not probable) outcome is that the tropical fish will eat the shark. Don’t bet on it.

Of course, the principal goal of the bankruptcy clause of a lease is to terminate the leasehold estate in case the tenant becomes a debtor pursuant to a case commenced under the Bankruptcy Code (also known as the Bankruptcy Reform Act).

The termination of the leasehold estate as a result of the tenant’s bankruptcy would mean the complete forfeiture of the leasehold mortgagee’s investment. The possibility that the leasehold estate will terminate as a result of a bankruptcy of the tenant-developer would be far more worrisome to a leasehold mortgagee than a termination as a result of a default were it not for one of the delightful provisions of Section 365 of the Bankruptcy Code.

“(e)(1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or an unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on—

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;
(B) the commencement of a case under this title; or
(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.”

In short, Section 365(e) of the Bankruptcy Code clearly blocks a landlord from terminating a leasehold estate as a result of most of the events described in the long and dreary run-on sentences I see over and over again in bankruptcy clauses.

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If Section 365(e) works this wonder, why do some prospective leasehold mortgagees still find bankruptcy clauses so disagreeable? One reason is that it is possible that the bankruptcy statute will be amended in the future to permit landlords to cancel leases as a result of bankruptcy or insolvency. However, that’s not the only reason.

A much greater irritant to a leasehold mortgagee is the junk that extends the scope of ground lease bankruptcy clauses to many circumstances that have no relationship or only a peripheral relationship to bankruptcy.

Why are nonbankruptcy events dealt with in ground lease bankruptcy clauses? My guess is that the genesis of this idea is more psychic than intellectual. Bankruptcy sounds ominous, and so do some of the other events. One less than knowledgeable legal draftsman of the distant past must have made the connection and included them in one of his bankruptcy clauses. Regretfully, as a result of the curious devotion lawyers have for copying the work product of earlier generations (even if drafted ineptly and illiterately), his form may have found its way into a form book. And the rest of us have inherited the burden of trying to understand what was bothering this unsung anonymous ancestor.

Here’s a list of some events, which, although not directly related to bankruptcy, smelled like bankruptcy to the long forgotten authors of the poorly drafted ground lease forms that are still used mindlessly.

1. An assignment for the benefit of creditors.
2. The failure to discharge a judgment or an attachment.
3. The dissolution of the tenant.
4. The appointment of a receiver or a trustee of any of the tenant’s property.

A leasehold mortgagee can’t stop a tenant from assigning its assets for the benefit of creditors. Assignments for the benefit of creditors are not governed by the Bankruptcy Code; so Section 365(e) won’t protect the leasehold mortgagee against a termination.

Granting a landowner the right to terminate a ground lease because of the tenant’s failure to discharge a judgment or an attachment or because of the appointment of a receiver or trustee of any of the tenant’s assets (in a nonbankruptcy proceeding) falls into the silly category. By itself, a tenant’s failure to discharge a
judgment does no harm to a ground lessor and doesn’t even indicate that the tenant’s financial position has deteriorated. Many shopping center owners have default judgments outstanding for parking lot accidents for no reason other than a failure of their liability insurance companies to have answered a summons and complaint properly.

The appointment of a state court receiver to take control of one apartment house owned by a tenant who owns another fifty buildings is not significant in this context and should not trouble a landowner.

Dissolution of a tenant is no big deal, and it shouldn’t bother a landowner at all. Many partnerships are ground lease tenants. If a partnership dissolves, the partners become tenants-in-common, or a reconstituted partnership becomes the tenant. So what!

On the other hand, if the dissolution of the tenant can cause a termination of the leasehold estate, the ground lease won’t be mortgageable. A leasehold mortgagee doesn’t have the power to stop these events from happening or the power to cure them in case they do happen. A lender that would accept a ground lease which includes such a provision as security would be in jeopardy of losing its investment without the opportunity to protect itself.

[5]—New Lease Provisions

[a]—New Lease Provisions and Default.

A new lease provision might be a significant element of the ground lease package needed to satisfy a prospective holder of an unsubordinated leasehold mortgage.

Its function is to provide a second line of defense for the mortgagee against the possibility that the lease will be terminated as a result of an event of default, an event of bankruptcy, or some wacky termination clause concocted by future generations.

A new lease clause simply provides that, if the lease is terminated for any reason, the landlord agrees to lease the premises to the holder of the leasehold mortgage.

All of the provisions of the new lease should be the same as the original lease with a few obvious exceptions. The term of the new lease should be reduced to take into account the portion of the term of the old lease which will have expired. For example, if the new lease is executed in the tenth year of the term of the original lease, all of the rights and obligations of the landlord and the new tenant (the
leasehold mortgagee) in the first year of the new lease term should be the same as they would have been in the eleventh year of the old lease. Of course, if the leasehold improvements will have been built, any clauses dealing with the original construction of the leasehold improvements should be deleted.

[b]—New Lease Provisions and Bankruptcy.

The new lease provision can play a positive role in dealing with problems stemming from the Bankruptcy Code. Although a bankruptcy court won’t enforce a lease clause that grants a landlord the right to cancel a lease as a result of the bankruptcy or insolvency of a tenant, it is still possible that a leasehold estate will be terminated as a result of a bankruptcy.

If the tenant-developer becomes a bankrupt, the tenant-developer’s trustee (or the tenant-developer in its capacity as debtor-in-possession) will have the power to reject the lease. A leasehold mortgagee has no magic formula to insert in the leasehold mortgage that is certain to prevent a rejection of a lease by a tenant-developer’s trustee. Even a prohibition against rejection in the leasehold mortgage appears contradictory to the express powers of a tenant-developer’s trustee pursuant to the language of the Bankruptcy Code. Nevertheless, there ought to be a remedy for a leasehold mortgagee, and the United States Constitution might provide one.

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6 In Cherkis and King, Collier, Real Estate Transactions and the Bankruptcy Code, § 2.02 (1984), the authors suggest that leasehold mortgages contain a provision pursuant to which the tenant-mortgagor agrees not to reject the lease under § 365(a) of the Bankruptcy Code and assign the leasehold estate to the mortgagee instead. For its part, the mortgagee would assume the tenant-mortgagor’s obligations under the ground lease and cure any outstanding defaults. Although the provision is certainly a good idea, I can’t predict how a bankruptcy court would react to it.
7 Section 365 of the Bankruptcy Code provides that, “Except as provided in Sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.” 11 U.S.C. § 365(a).
8 The United States Constitution and equitable principles could influence a court’s decision as to whether to permit the trustee of a ground lease tenant-
A leasehold mortgagee can find a measure of protection against this problem by refusing to lend any money against the security of a ground lease unless the ground lease or a tripartite agreement requires the landowner to enter into a new ground lease with the leasehold mortgagee in case the leasehold estate is terminated for any reason including a rejection of the ground lease by the tenant-developer in case the tenant-developer becomes a debtor under the Bankruptcy Code.

[c]—Infirmities of the New Lease Provision.

A new lease clause is no panacea and doesn’t solve all of the problems caused by a termination of the original ground lease.

Suppose that, immediately prior to the termination, the land is subject to the lien of both a fee mortgage and a ground lease and that the lien of the fee mortgage is subordinate to the lien of the ground lease. This poses no problem for a leasehold mortgagee unless the leasehold estate is terminated and the leasehold mortgagee is forced to rely on whatever solace it can get from the new lease clause. The problem is that, when the leasehold estate (pursuant to the original ground lease) is terminated, the original ground lease vanishes as a lien against the land, and the fee mortgage becomes the first lien against the land. Then, when the landlord and leasehold mortgagee actually execute the new lease pursuant to the provisions of the new lease clause, the new leasehold estate will be subordinate to the lien of the fee mortgage. Of course, it’s better for the mortgage lender to acquire a leasehold estate that is subordinate to the lien of a fee mortgage than to acquire no leasehold estate at all. However, the solution is far from perfect.

One possible way to deal with this issue is for the original ground lease to prohibit the landlord from mortgaging his fee simple (ownership) estate at all or to require that any existing or future fee mortgage provide that the lien of the mortgage will be subordinate not only to the lien of the original ground lease but to any new ground lease executed pursuant to the new lease provision as well.

mortgagor to reject a ground lease when the leasehold estate is encumbered by a mortgage. For an interesting discussion of the relationship between the United States Constitution and the Bankruptcy Code, see Rogers, “The Impairment of Secured Creditors’ Rights in Reorganization: A Study of the Relationship of the Fifth Amendment and the Bankruptcy Clause,” 96 Harv. L. Rev. 973 (1983).
Even if the lien of the new lease is paramount to the lien of an intervening mortgage, a mortgagee who relies on a new lease provision might be faced with paramount mechanics’ and materialmen’s liens and the claims of the landowner’s creditors. Any lien against the fee estate that is subordinate to the lien of the original ground lease when it is terminated might be paramount to the lien of a new lease.

One commentator has concluded that a new lease provision is an option. He maintains that the rule against perpetuities might void an option that is likely not to vest within the period required by the rule.

Although it is certainly possible for a court to come to such a conclusion, the decision would be inappropriate and destructive. Public policy should and does favor the avoidance of forfeitures. Applying the rule against perpetuities to a new lease provision could (under extreme circumstances) result in the forfeiture of a lender’s entire investment in a project. The application of the rule against perpetuities to this or any other lease provision does no good to anybody and has no useful social purpose.

[6]—Right of Election Under Bankruptcy Code § 365(h)

It is conceivable that a ground lease landlord might become a debtor under the Bankruptcy Code. As such, the landlord’s trustee would have the right to reject the lease.

Section 365(h) of the Bankruptcy Code provides that, if a landlord is a debtor under the Code and rejects a lease, its tenant has two options.

The tenant has the right to remain in possession and enjoy the fruits of the lease notwithstanding the rejection. If a lease rejected

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10 Section 365(h)(1) of the Bankruptcy Code provides that, “If the trustee rejects an unexpired lease of real property of the debtor under which the debtor is the lessor, or a timeshare interest under a timeshare plan under which the debtor is the timeshare interest seller, the lessee or timeshare interest purchaser under such lease or timeshare plan may treat such lease or timeshare plan as terminated by such rejection, where the disaffirmance by the trustee amounts to such a breach as would entitle the lessee or timeshare interest purchaser to treat such lease as terminated by virtue of its own terms, applicable nonbankruptcy law, or other agreements the lessee or timeshare interest purchaser has made with other parties; or, in the alternative, the lessee or timeshare interest purchaser may remain
by the landlord requires the landlord to perform services for the tenant and the tenant elects to remain in possession, the landlord’s obligation to perform services becomes unenforceable. Instead, the tenant gets the right to “damages” caused by the landlord’s failure to perform. A leasehold mortgagee isn’t much concerned about a landowner performing services pursuant to ground lease obligations. Few landowners agree in a ground lease to perform any obligation except to execute applications for permits, licenses, and zoning variances.

What frightens a leasehold mortgagee about the possibility that the landowner will file for protection under the Bankruptcy Code is that the tenant gets the option to accede to the rejection of the lease by the landlord. If the tenant accedes to the rejection, the leasehold estate ends. Since, under these circumstances, the landlord’s behavior and not the tenant’s behavior is subject to the approval of the bankruptcy court, the authors of Collier’s say that the mortgagee might protect itself by requiring the tenant to assign to the mortgagee the tenant’s right of election to accede to a rejection of the ground lease by the bankrupt landlord. To this end, the lease itself can provide that the tenant is entitled to assign this right of election to the leasehold mortgagee. It would be even better to provide that the right of election under Section 365(h)(1) of the Code will be

in possession of the leasehold or timeshare interest under any lease or timeshare plan the term of which has commenced for the balance of such term and for any renewal or extension of such term that is enforceable by such lessee or timeshare interest purchaser under applicable nonbankruptcy law.” See 11 U.S.C. § 365(h)(1).

The Bankruptcy Code contains this provision:

“If such lessee or timeshare interest purchaser remains in possession as provided in paragraph (1) of this subsection, such lessee or timeshare interest purchaser may offset against the rent reserved under such lease or money due for such timeshare interest for the balance of the term after the date of the rejection of such lease or timeshare interest, and any such renewal or extension thereof, any damages occurring after such date caused by the nonperformance of any obligation of the debtor under such lease or timeshare plan after such date, but such lessee or timeshare interest purchaser does not have any rights against the estate on account of any damages arising after such date from such rejection, other than such offset.” See 11 U.S.C. § 365(h)(2).


14 Id., at § 2.01.
assigned automatically to the leasehold mortgagee when the mortgage is executed and may be exercised solely by the leasehold mortgagee. If a leasehold mortgage loan is repaid and the tenant-borrower mortgages the leasehold estate again, the new leasehold mortgagee should have the sole right to exercise the tenant’s right of election under Section 365(h)(1).

Here too, the new lease provision may come in handy. Just in case the assignment of the right to accede to a rejection doesn’t work, the leasehold mortgagee can fall back on the new lease provision.

[7]—Arbitration

Why is a leasehold mortgagee worried about an arbitration clause in a ground lease? What’s to worry about?

If a ground lease arbitration clause provides that the landowner and the tenant each are to choose one arbitrator and the two arbitrators chosen by the landlord and the tenant are to choose a third arbitrator, the leasehold mortgagee would have no say in the process. If the leasehold mortgagee has no say in the process of selecting the arbitration panel, its point of view as to any potential dispute might have no clout.

If the lease also provides that the landowner has the power to terminate the lease in case of a default by the tenant, the power of the arbitrators to determine whether a default will have occurred could be exercised destructively. Of course, the ultimate fear is a combination of lease provisions that could result in a termination of the leasehold estate as a result of a decision by arbitrators selected pursuant to a process that excludes the leasehold mortgagee from participation.

The moral of the story is that, if you want an unsubordinated ground lease with an arbitration clause to be mortgageable, the lease should give the mortgagee the opportunity to participate in the arbitration process. If the panel is to have three members, provide that the landowner can pick one, the leasehold mortgagee can pick another, and the arbitrators selected by the landowner and the leasehold mortgagee can pick the third. If the arbitrators are to be selected by an impartial organization subject to rejection by a party to the dispute, the lease should provide that the leasehold mortgagee has the option to exercise what would otherwise be the tenant’s right of rejection.
Exculpation clauses are found in many ground leases and are almost always present in ground leases negotiated by sophisticated attorneys.

The basic principle of a ground lease exculpation clause is that all liability of the landlord to the tenant under the lease is limited to the landlord’s fee simple estate in the land and all liability of the tenant to the landlord is limited to the tenant’s leasehold estate.

Exculpation clauses are vital for tenant-developers. Many tenant-developers are individual persons or partnerships of which individual persons are general partners. Without an exculpation clause, the execution of a ground lease would expose all of the assets of the tenant (or the tenant’s general partner as the case may be) to the liabilities that arise from the ground lease. Since the term of a ground lease necessarily lasts beyond the normal life expectancy of most adult human beings, a tenant-developer should do what he can to limit the exposure he undertakes by executing the lease. Unless the parties expect that an existing building will be demolished, the tenant-developer’s credit is usually not a significant factor in ground lease negotiations. The mere presence of the leasehold improvements serves as security for the tenant-developer’s covenants under a ground lease. The prospect of losing such a valuable asset should deter any sane tenant-developer from defaulting.

Ground leases are different from occupancy leases in this respect. The space occupied by the tenant-occupants is constructed by their landlord-developer. The funds needed to pay the cost of construction of the space occupied by the tenant-occupants are provided by the landlord-developer’s mortgagee in reliance on the income stream to be generated from the occupancy leases. Thus, in the case of an occupancy lease, it’s appropriate to provide for the exculpation of the landlord-developer but not for the tenant-occupant. On the other hand, a ground lease landlord doesn’t pay for any construction; the tenant-developer and leasehold mortgagee do that. Furthermore, a leasehold mortgagee doesn’t lend in reliance on the rent payable by the tenant-developer pursuant to the ground lease. It relies on the rent payable by the subtenant-occupants pursuant to the occupancy subleases.

A ground lease clause that provides that the liability of the tenant to the landowner is limited to the leasehold estate should encourage a
leasehold mortgagee. A leasehold mortgagee knows that, if it ever forecloses the leasehold mortgage, it might become the tenant. It also knows that, under some ground leases, assignees of the leasehold estate are required to assume the obligations of the assignor. A leasehold mortgagee that becomes the tenant as a result of a foreclosure would be an assignee and, accordingly, might be required to assume the assignor’s liability. Even when the lease doesn’t require an assumption, a leasehold mortgagee fears the possibility that, if it succeeds to the ownership of the leasehold estate, the liabilities of the tenant-assignor (the borrower) will be imputed to it because of its new role as the tenant-assignee and that these liabilities will be unlimited. Leasehold mortgagees are often very substantial banks and insurance companies. It is understandable that a bank or insurance company would be reluctant to assume the liability of its borrower (the tenant) to a landowner as a condition of foreclosing a leasehold mortgage. The tenant’s exculpation clause limits this exposure.

Some ground lease deals do depend on the credit of the tenant and don’t have exculpation clauses. Most of these are leases for land to support compact restaurants or bank sites in a shopping center. This kind of ground lease is distinguished from the others by the tenant’s intent to use the leasehold improvements for its own business instead of subletting them to others. Another distinction is that the sites are usually small and derive their value from their presence in an integrated shopping center complex.

How do you protect a leasehold mortgagee in the type of ground lease deal in which the tenant’s credit is a factor and the landlord appropriately requires the tenant to be personally liable? Even if the tenant is willing to expose all of his own assets to possible claims of the landowner, he still must anticipate the leasehold mortgagee’s reaction. The leasehold mortgagee’s reaction to a ground lease without an exculpation clause with respect to the tenant’s liability should be negative unless the lease contains a clause that at least limits the leasehold mortgagee’s liability in case the leasehold mortgagee ever succeeds to the interest of the tenant under the ground lease. The least a leasehold mortgagee should settle for is a clause that provides that the mortgagee’s liability will be limited to events occurring when it is the owner of the leasehold estate and that, upon its disposition of the leasehold estate, it will be relieved of any further liability to the landowner.