

3-01 SUBORDINATED GROUND LEASES GROUND LEASES AND LAND ACQUISITION CONTRACTS

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§ 3.01 What's a Subordinated Ground Lease?

One reason why ground leases are interesting is that they differ so much from each other. A ground lease clause that is perfectly reasonable in one context is absolutely preposterous in another. In particular, the presence or absence of a *subordination clause* influences many other ground lease clauses profoundly.

Ground lease *subordination clauses* usually have nothing to do with the classical concept of subordination. Real estate developers and their lawyers (who have never been the most articulate people in our society) have confused the two ideas. I figure that the confusion began when developers who were accustomed to buying land for a large purchase price and a small downpayment shifted to ground leasing. Before they shifted to ground leasing, their negotiations to purchase land focused on the amount of the purchase price and how and when the purchase price would be paid. To the extent they could, many would attempt to defer as much of the purchase price as possible and for as long as possible. The deferred portion of the purchase price was usually secured by a purchase money mortgage. Naturally, many of these developers became adept at negotiating the provisions of their deferred payment purchase money mortgages.

Some of these provisions necessarily dealt with the developer's subsequent efforts to develop the project and finance the cost of development.

As you know, almost all developers need to finance the cost of constructing improvements to the land (and sometimes the cost of the land as well) by borrowing as much money as they can pursuant to a construction loan. Customarily, lenders insist that construction loans be secured by a *first* mortgage lien against the land and the buildings to be constructed.

Because of his need to grant a *first* mortgage to secure a construction loan, a developer who purchased land, deferred payment of a part of the purchase price, and secured the deferred payment with a purchase money mortgage was faced with two alternatives. He could convince the construction lender to lend him additional funds and use these funds to pay off the deferred payments due with respect to the purchase money land mortgage, or he could convince the landowner to subordinate the lien of the purchase money land mortgage to the lien of the construction loan mortgage.

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Clearly, purchaser-developers usually preferred to convince landowners to subordinate the lien of a deferred payment purchase money land mortgage rather than to borrow more money from their construction lenders and pay off the landowners with the additional funds. Interest payable on purchase money mortgages was often much lower than interest payable on construction loans. In addition, construction lenders prefer to lend less than the entire project development cost and want to know that someone other than the lender has money in the deal. That someone can be the landowner.

Accordingly, the developers learned that they usually ended up needing much less of their own cash if they did not pay off the debt secured by a purchase money land mortgage when the construction loan mortgage was executed and got the landowner to subordinate the lien of the land mortgage to the lien of the construction loan mortgage (and later on, to the lien of the permanent loan mortgage).

As some developers learned that you need *even less cash* when you lease land rather than buy it, I figure that they jumped into the new way of dealing with much exhilaration but without much preparation or understanding. It seems to me that the developers' negotiators just superimposed the way they drafted purchase money mortgages on the ground leases they confronted without bothering to learn much about the new subject matter. They knew how to talk to a landowner from whom they were purchasing land for a little cash and a lot of deferred payments secured by a purchase money mortgage; they'd try to convince him that the lien of his purchase money mortgage should be subordinated to the lien of a mortgage securing a construction loan or a construction loan and permanent loan. Unfortunately, when they were negotiating ground leases instead of purchase money mortgages, they approached the document in exactly the same way. They (absurdly) asked the landowner to subordinate his *land* (or the ground lease) to one, two or all mortgages the tenant might want executed. Just as absurdly, many landlords agreed to "subordinate" their *land* to one or more mortgages, and the concept of a "subordinated ground lease" was born.

Of course, you can't subordinate *land* to anything, and the idea of a landlord subordinating *land* to a mortgage is nonsense.

Actually, a properly drafted subordinated ground lease should not require the landowner to subordinate anything. It should require the landowner to *execute a mortgage (or mortgages) of his land to*

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accommodate a loan (or loans) made to the tenant for the purpose of developing the land. Subordination is meaningless in this context.

Ground leases that obliged the landlord to mortgage his land to accommodate loans made to the tenant also became known as subordinated ground leases, and calling these leases “subordinated ground leases” became a habit. The habit is so strongly embedded that I call them subordinated ground leases too.

Similarly, leases that don’t oblige the landlord to execute mortgages to accommodate loans to the tenant became known as unsubordinated ground leases.

The need to borrow most or all of the cost of development from an institutional lender pursuant to a mortgage loan is common to purchaser-developers and tenant-developers.

Purchaser-developers can provide security for their mortgage loans by mortgaging the fee simple (ownership) estate: they can forget about landowners after they buy and pay for the land. Tenant-developers usually attempt to solve their need to provide adequate security for their mortgage loans by taking one of two paths. Sometimes they try to organize an unsubordinated ground lease in a salutary way so that an institutional lender would be willing to lend the funds needed to develop the project against the security of the leasehold estate alone. More often they try to convince the landowner that the deal won’t work unless he agrees to execute a mortgage to secure a loan to be made to the tenant-developer for the purpose of financing the development.

A landowner’s decision as to whether he will or will not execute a mortgage of his land to accommodate a loan to be made to a tenant-developer has profound consequences on the risks to be taken by the landowner, the institutional lender, and the tenant-developer. If a landowner executes a mortgage to secure a loan made to the tenant-developer, the landowner faces the possibility that he will lose his land entirely in case the tenant fails to pay the mortgage debt or in case the tenant is in default under the mortgage documents in other respects. On the other hand, if the ground lease doesn’t require the landowner to execute a mortgage of the land (in real estate slang, the lease is unsubordinated), the mortgagee faces the possibility that he will lose the sole security (the leasehold estate) for its investment in case the tenant defaults under the ground lease. In a financial climate in which lenders of a large percentage of commercial permanent mortgage loans customarily agree to limit the borrower’s liability to

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the proceeds of the security and not to seek repayment from other assets of the borrower, the loss of the security can mean the loss of all hope for repayment.

Given this state of affairs, the most significant issue that must be faced by the parties to a ground lease is whether the landlord will *subordinate* (execute a mortgage of his land to secure a loan made to the tenant). If the landlord refuses to *subordinate*, the tenant's reaction to the other clauses of the ground lease must be influenced by the need to convince a mortgagee to lend against the security of the leasehold estate alone. However, if the landlord agrees to *subordinate*, the landlord's reaction to many other clauses of the ground lease must be influenced by the risks he undertakes as a result of this decision including the risk of losing his land as a result of foreclosure of the mortgage.

When an unsubordinated ground lease is on the table, a landowner can afford to be liberal with his tenant; there's nothing much for the landowner to lose if the tenant abuses a privilege granted to him under the lease. However, when a landowner is willing to take the big plunge and agree to mortgage his land to secure a loan to be made to the tenant-developer, he should try to impose reasonable limits on the tenant-developer's activities. His attitude toward every other clause in the ground lease should be governed by this principle.

Although the aroma of *subordination* permeates all of a subordinated ground lease, its influence is felt most significantly in the following lease clauses:

- (1) Planning.
- (2) Construction.
- (3) The Term.
- (4) The Rent.
- (5) Use, Alterations, Demolition and Signs.
- (6) Repairs, Compliance and Surrender.
- (7) Destruction and Condemnation.
- (8) Assignment and Subletting.
- (9) Priority of Lien.
- (10) Estoppel Certificate.
- (11) Defaults and Bankruptcy.

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In this chapter, I'll focus on how the decision to subordinate colors these clauses and suggest variations from the way these clauses are drafted in unsubordinated ground leases.

Before we go any further, I'd like to stop using the word *subordinate* when I refer to the landlord's execution of a mortgage of his land to secure a loan made to his tenant. What's really happening is that a landowner is encumbering his land to *accommodate* his tenant's need to borrow money. So I call this kind of mortgage an *accommodation mortgage*, and I'll use that phrase for the balance of this chapter.