

3-02 SUBORDINATED GROUND LEASES  
GROUND LEASES AND LAND ACQUISITION  
CONTRACTS By Emanuel B. Halper

**§ 3.02 The Pre-Construction and Construction Processes**

**[1]—Planning and Site Preparation**

**[a]—The Landowner’s Vulnerability.**

Construction is fraught with danger for a landowner who executes an accommodation mortgage.

The most obvious danger is the possibility that the tenant-developer will be unable to manage the construction properly or that construction will be abandoned for one reason or another. Such an event might be a blessing in disguise for the landowner if the lease were an unsubordinated ground lease. If that were the case, and the tenant-developer abandoned the project after building only part of the leasehold improvements he planned to build, the landowner might have a good shot at a windfall. He might acquire something of value for no investment or effort as a result of a default by the tenant.

However, when a landowner has executed an accommodation mortgage, the most likely prospect in store for the landowner as a result of a tenant’s failure to comply with his construction obligations is disaster. Mismanaged or abandoned construction would probably be a default under the accommodation mortgage; the mortgage lender would be able to accelerate the debt and foreclose against the security. Since, in the case of a subordinated ground lease, the security also includes a mortgage of the landowner’s fee simple (ownership) estate in the land, the landowner might lose his land due to no fault of his own.

Naturally, a landowner who agrees to execute an accommodation mortgage should exhibit uncommon concern about the project the tenant intends to construct on the land. The construction process should be unraveled and examined from tip to toe to provide a relatively safe path for the landowner.

**[b]—Demolition of Existing Structures.**

Before a developer even starts planning to build a new building, he may be required to cope with existing structures and their occupants. Sometimes the structures (and maybe the occupants as well) are dilapidated and have outlived their usefulness. On the other

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hand, some tenant-developers lease land improved by well preserved existing buildings that provide a valued stream of income for the landlord before the execution of the ground lease. In these circumstances, the landlord might be quite concerned about losing the structure and the income from its occupants.

Imagine leasing your land (improved by ancient but occupied buildings that generate an income providing the means for your monthly spree in Monte Carlo) to a hot shot developer. He evicts the occupants, demolishes the buildings, and later files a petition for relief as a debtor in a bankruptcy court. Certainly, his behavior will make you unhappy. You will be unhappier still when you realize that the buildings have been demolished and that they will never have another occupant to send you those delicious rent checks. But you will be most unhappy when you remember that you executed a mortgage to secure a loan made to the tenant to finance the demolition and eviction, that the tenant is in default with respect to the loan, and that the lender intends to take away your land also.

No landowner should execute an accommodation mortgage securing a construction loan unless he gets practical assurances from the tenant-developer that the debt will be repaid from a source other than a foreclosure sale of the land. A tenant-developer should not be permitted to demolish a building that was situated on the land before the execution of the lease or evict its occupants unless he agrees to build a much better building and provide tangible financial assurances that the much better building will be completed within a reasonable time. The best way for the landowner to be protected against calamities is to make sure that the tenant chosen to develop the land knows what he is doing and has the financial clout to make the development work. Assuming that the developer is an okay guy (or girl), a landowner can find a measure of protection against the very real dangers of the planning and construction process by getting personal guarantees of the developer, a security deposit, a letter of credit, or a combination of them.

Although tenant-developers are reluctant to provide personal guarantees or other financial assurances of their ground lease obligations to their landlords, some of them are quite willing to give temporary personal guarantees or other assurances to keep a landlord happy during the construction process. A tenant-developer who agrees to guarantee his ground lease obligations wants the guarantee to end when the value added to the land by the tenant-developer's

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construction activities is large enough to make a reasonable landowner feel secure from a foreclosure of an accommodation mortgage. Sometimes, a landlord might be sufficiently comfortable to release the personal guaranties or third party assurances when construction will have progressed to a point at which the new improvements are significantly better than the demolished improvements were just before they were demolished. In other circumstances, landlords won't agree to release the personal guaranties or third party assurances until construction is substantially complete and a new income stream is sufficient to pay the periodic mortgage payments and all of the project's other carrying charges.

#### **[c]—Describing the Leasehold Improvements.**

In unsubordinated ground leases, tenant-developers seldom agree to extensive limitations on the kinds of building that may be constructed on the leased land. Landowners are usually willing to play a completely passive role when an unsubordinated ground lease is on the table. They can afford to be passive. In the case of an unsubordinated ground lease, nothing very bad can happen to the landowner if the tenant-developer's project can't make it.

But a landowner who agrees to execute an accommodation mortgage can't afford to be completely passive as to the kind of building the tenant-developer expects to build. When he executes an accommodation mortgage, he risks losing his land to the mortgagee if the development proves to be unsuccessful. If the landowner is willing to take the risk that he will lose all he owns as a result of the tenant-developer's mistake, the tenant-developer should make a reasonable effort to assure the landowner that there won't be a mistake. Why shouldn't a landowner who assumes this risk know what the tenant-developer has in mind so that he can have the opportunity to decide for himself whether the prospect of getting ground rent is worth the risk.

To this end, a prudent subordinated ground lease landlord wants the ground lease to impose sensible limits on the way the land will be developed.

Of course, landowners can't expect complete control. A landowner who is smart enough to control every aspect of developing a project and has sufficient resources to effectuate the development doesn't need a relationship with a developer. He

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shouldn't enter into a ground lease in the first place and should build any project he wants for his own account.

The negotiation about the description of the kind of project that may be developed on the land must balance the fear of the landowner that the project will be a flop and that his birthright will be squandered against the (hopefully) superior personal and financial resources of the developer. The result should be a rather general description of the permissible improvements that will allow considerable flexibility to the developer on the one hand but protect the landowner against the construction of a white elephant on the other hand.

Ground leases are usually executed long before a tenant-developer can make a detailed commitment to construct a particular type of building. However, tenant-developers can commit themselves, even at the outset, to criteria that will be sufficient to calm even a very nervous landowner. The criteria should include at least a general description of the scope of the project, the expected use of the buildings, the height of the buildings, the number of stories, and the approximate floor area. Of course, the developer should be able to choose from several different alternative types of buildings. Likewise, the criteria dealing with the height and floor area of the buildings should give the developer enough latitude to make prudent business decisions.

When the landowner and tenant-developer agree on criteria for the buildings to be constructed, the landowner can relax for a while. The tenant-developer has a great deal of work to do before his next significant move. Before developers build on a site, they usually investigate site conditions, search title, prepare environmental studies, and gather other relevant information about the land. They also (usually) plan their project, organize a construction program, prepare conceptual drawings, and make arrangements to borrow the funds they need to finance construction. In the case of commercial and industrial developments, they try to lease large blocks of space to important tenants before they start building.

Ultimately, a tenant-developer will employ an architect to prepare plans and specifications for construction of the proposed improvements. Plans and specifications are developed in stages pursuant to a procedure that involves consultation, criticism and negotiation between the developer and the architect.

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A landowner who agrees to execute a subordinated ground lease should want to play a role in this process. Naturally, he should not be in a position to dictate to the tenant-developer or to pass on the decorative aspects of the building. However, he should be able to review the plans and specifications at various stages and be able to squawk if the plans vary materially from the criteria established in the ground lease or fail to comply with applicable legal requirements.

The culmination of the process of developing plans and specifications is a set of detailed specifications and working drawings. The detailed specifications and working drawings later become a part of a general construction contract between the tenant-developer and a construction contractor. When the construction contract is executed, the most anxiety provoking part of the biography of a subordinated ground lease is about to begin.

#### **[2]—Construction**

##### **[a]—The Vulnerability of the Landowner to Construction Problems.**

Until a landowner actually executes an accommodation mortgage, he needn't lose much sleep worrying about the quality or progress of construction. As long as the tenant doesn't ask the landowner to take the big risk, the absence of construction shouldn't be excessively troublesome to the landowner. Nevertheless, this principle has its limits too. A landowner should understand that, unless the tenant-developer actually builds buildings on the land, the landowner won't get the benefit of the bargain. It's the buildings and other improvements created by the tenant-developer that make a ground lease relationship work. The buildings are the foundation for the occupancy subleases, and they, in turn, are the support system for the income stream of the project and the ultimate source from which the tenant-developer derives the funds to pay ground rent and carrying charges.

A landowner should insist that the tenant-developer at least begin to construct the project before the end of a generously long preconstruction period. Even a generously long time period ends some day, and a tenant-developer who can't even start to build his project by then should drop the site and give someone else a chance.

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A landowner's concern about construction should increase significantly when he is called upon to execute an accommodation mortgage securing a construction loan.

The fact that a landowner has executed or is required to execute a mortgage of his land to secure a loan made to the tenant should cast a heavy shadow on the construction clause of a ground lease. The knowledge that he is obliged to execute accommodation mortgages conjures images of the possible loss of his property as a result of a mishap in the construction process. He should keep these images in his mind when he negotiates the construction clause.

Construction creates many other problems for subordinated ground lease landlords. The tenant-developer's failure to pay a construction contractor or supplier can result in the land being encumbered by a mechanics' lien or materialman's lien. The landowner might be liable to third parties for injuries suffered because of construction accidents. The landowner might be fined or otherwise penalized by governmental entities for violations of legal requirements. He may be showered with complaints by neighbors because of dust, noise, dirt, rubble, odors and off-color remarks by construction laborers—on and on.

What kind of relief can he get from ground lease provisions?

#### **[b]—The Influence of Construction Loan.**

Developers don't usually build buildings with their own money. Long before they start building, they busy themselves with making arrangements for loans to finance the cost of development. Most developers won't even break ground for construction until construction loan commitments for the project have been executed. In fact, construction loan mortgages are usually executed and recorded *before* construction begins.

A subordinated ground lease landlord is asked to execute an accommodation construction loan mortgage instrument at the same time the tenant-developer does so. He doesn't have the luxury of inspecting completed buildings before he executes the mortgage instrument. He can't ask that the construction mortgage closing be postponed until he determines whether the construction conforms to the ground lease, to the plans and specifications, and to legal requirements. He must execute the mortgage document *at the beginning* of the construction process.

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Unless a subordinated ground lease provides for appropriate prerequisites to the obligation to execute an accommodation mortgage and provides for additional safeguards after the mortgage is executed, the only way for the landlord to protect himself will be to pray that he will be shielded from harm by divine providence or by the integrity of the tenant-developer.

When a developer executes a construction loan mortgage, he is usually required to execute a construction loan agreement as well. Among other things, construction loan agreements usually set forth procedures for the disbursement of loan proceeds and provide for many covenants and warranties on the part of the mortgagor-developer (who, in the context of a ground lease, is also the tenant). Construction loan agreements usually contain cross-default provisions under which the mortgage debt will be accelerated in case of a default under the loan agreement as well as a default under the mortgage. Needless to say, the acceleration of a mortgage debt caused by a default under a construction loan agreement is just as destructive to the interests of a landowner as the acceleration of a mortgage debt caused by a default under the mortgage.

Accordingly, a subordinated ground lease landlord needs assurances that the tenant-developer will comply with all of his obligations as the mortgagor under the accommodation mortgage and all of his covenants as the borrower under the additional documents executed in connection with an accommodation mortgage including the construction loan agreement.

Construction lenders don't want to sit around for long indefinite periods until their borrowers are good and ready to begin construction and borrow the money. They want to specify a date on which they will know definitely whether the money will or will not be borrowed. Consequently, a construction loan agreement customarily requires that construction begin by an agreed upon date.

Construction lenders dislike being the sole source of funds for a project. Because of this dislike, some construction loan agreements provide that the tenant-borrower-developer invest a fixed amount of his own funds in the project before any of the construction loan proceeds are disbursed. They also demand that the tenant-borrower-developer personally guarantee the substantial completion of the project on or before a mutually agreed completion date. To make sure that the guarantee is meaningful, they demand to know that the developer has sufficient financial resources to bridge the gap

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between the project development cost and the proceeds of the construction loan.

Construction lenders are usually very careful about disbursing construction loan proceeds. Most of the time, a construction loan agreement will provide for monthly disbursement of loan proceeds to the borrower-developer. The developer (who, in the case of a ground lease, is also the tenant) is able to get the money only in bits and pieces as his contractors perform the construction work, and he must use the loan proceeds to pay off the contractors. The amount of the disbursements is usually determined by references to certificates of architects and engineers. The architects or engineers, in turn, base their certificates on their observations, on tests they make, and on requisitions submitted by contractors and subcontractors.

Of course, each disbursement of loan proceeds increases the burden of the lien of the construction loan against the property of a landowner who has executed the mortgage instrument.

Consequently, the obligations undertaken by a tenant-developer pursuant to a construction loan agreement are of concern to a subordinated ground lease landlord as well as the tenant-developer. Although the tenant-developer will be primarily liable for the performance of these obligations, his failure to perform them will spell trouble for the landowner. A default under the construction loan agreement is likely to be a default under the accommodation construction loan mortgage as well, and a default under the accommodation mortgage can result in an acceleration of the accommodation mortgage debt.

#### **[c]—The Influence of Lien Laws.**

Contractors who construct improvements to property on behalf of developers and don't get paid by the developers are sometimes in a position to seek payment from the value of the property itself. They can do this pursuant to the lien laws of various states.

Lien laws are very different from each other, and this is not the place to deal with them in depth. What's important for our purposes is that lien laws create a potential claim (or lien) against a project for the agreed price or value of work performed or materials supplied by an unpaid contractor. This kind of lien is called a mechanics' lien when a contractor that performs work is involved and a materialman's lien when a supplier of materials is involved. A

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mechanics' lienor and a materialman's lienor have the right to foreclose against the liened property to recover the amount that should have been paid.

Lien foreclosure is another way for the landowner to lose his land. Of course, a landowner really doesn't care whether he loses his land to an accommodation mortgagee or a mechanics' lienor.

#### **[d]—The Progress of Construction.**

A subordinated ground lease landlord should bargain for provisions to regulate the progress of the construction of the leasehold improvements. He needs these provisions for protection against a violation of the tenant-developer's covenants pursuant to a construction loan agreement; because of his vulnerability to mechanic's liens; and because of his concern about potential tort liability, violations of legal requirements, and relationships with neighbors.

#### *[i]—Obligation to Begin Construction.*

A subordinated ground lease should be sensitive to the tenant-developer's need for time in which to investigate site conditions, prepare plans and specifications, apply for governmental approvals, conduct an economic feasibility study and attempt to evoke interest in the site by prospective subtenant-occupants,

Of course, these preconstruction activities can't go on forever. There should be a specific date by which the tenant-developer agrees that he will begin construction or give up his attempt to develop the site. If he is unable to put his deal together after a fair chance to do so, he should not stand in the way of the possibility that someone else might be able to do so.

Any date specified in the lease for construction to begin should be subject to adjustment for a number of reasons.

The date should be subject to postponement if the tenant-developer is unable to get started by then because he has been delayed by an overwhelming event or circumstance such as a strike or other labor dispute, a calamity like a fire or explosion, or a cause beyond the tenant-developer's control.

Conversely, the construction commencement date should be subject to acceleration if the landowner is asked to execute an

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accommodation mortgage that requires construction to begin before the date specified in the lease.

##### *[ii]—Obligation to Prosecute Construction.*

Assuming that the landowner will probably have executed an accommodation construction loan mortgage before or shortly after construction operations will have started, it's important for the ground lease to require that the tenant-developer prosecute construction diligently subject to excusable delays. If the construction loan agreement requires the tenant-developer to adhere to a timetable for completion of any aspect of construction by a specific date, the requirement of the construction loan agreement should be incorporated in the ground lease.

Unlike a mortgagee, a subordinated ground lease landlord is not lending funds and doesn't have the opportunity to take charge of disbursing loan proceeds. However, he is taking a special risk when the construction loan is being disbursed and deserves to know what's going on. A subordinated ground lease should require the tenant-developer to report monthly to the landowner on the progress of construction and the disbursement of the construction loan proceeds. Copies of the contractors' requisitions and the architect's or engineer's certificates should be forwarded to the landowner.

##### *[iii]—Obligation to Complete Construction.*

A subordinated ground lease landlord who has executed an accommodation construction loan mortgage should worry about the completion date provisions of the construction loan agreement. If the construction work isn't finished by the completion date specified in the construction loan agreement, the lender will have the right to discontinue further disbursement of loan proceeds and to accelerate the debt. Of course, the ground lease should also specify a construction completion date and provide that the tenant-developer is required to substantially complete construction of the leasehold improvements on or before that date.

Because of the extraordinary risks assumed by the landowner during the period that begins when he executes an accommodation construction loan mortgage and ends on the substantial completion of the construction work, the landowner should insist on a personal

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guaranty of completion by the tenant-developer or a principal of the tenant-developer.

##### **[e]—Payment for Construction.**

A subordinated ground lease landlord should certainly bargain for a lease clause that obliges the tenant-developer to pay for the cost of construction and to discharge mechanics' and materialmen's liens.

Although the tenant-developer should certainly agree to pay for the cost of construction and keep the premises free of mechanics' and materialmen's liens, the ground lease should be flexible enough to permit the tenant-developer to quarrel with a contractor without permitting the contractor to use the ground lease covenant against liens as a weapon against the tenant-developer.

If the ground lease obliges the tenant-developer to discharge a mechanics' or materialmen's lien regardless of the validity of the claim that underlies the lien, the landowner might unwittingly force the tenant-developer to pay an unjust claim. A contractor who knows or surmises that the tenant-developer is obliged to discharge mechanics' and materialmen's liens by his ground lease or construction loan agreement might conclude that he has nothing to lose by making a claim and filing a lien even if he doesn't intend to prosecute the claim. Perhaps he'd figure that a covenant against liens in a ground lease or a construction loan agreement would force the tenant-developer to settle.

To make it possible for the tenant-developer to resist unjust claims, the covenant against liens should permit the tenant-developer to postpone its obligation to discharge a lien if the lien is contested. Even if the tenant-developer doesn't contest the lien, he should be permitted to delay discharging it unless the contractor begins proceedings to foreclose the lien.

Landowners who agree to execute an accommodation mortgage seek additional protection against the risk that the construction cost will get out of hand and that the tenant-developer will be unable to pay for it. Some subordinated ground lease landlords perceive that they will be better off if the tenant-developer enters into a construction contract with a reputable general contractor. And they perceive themselves as being still better off if the construction contract provides for a fixed or guaranteed maximum price.

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A fixed price or guaranteed maximum arrangement is not the only way to compensate a general contractor for constructing improvements, and many developers prefer not to deal with general contractors at all. Many developers have the knowledge, experience and ability to take full charge of construction themselves and have no need to deal with a general contractor. It's in the best interest of a subordinated ground lease landlord to minimize the project development cost, and a stipulated sum or guaranteed maximum contract isn't always the best arrangement to achieve this goal. A general contractor doesn't agree to a fixed contract price, and a construction manager doesn't agree to a guaranteed maximum price, without extra remuneration for the risks he undertakes. He'll probably add liberal allowances for contingencies to his projection of the construction cost and substantially increase his objectives for profits to compensate for the risks. The project development cost increase that arises because of the stipulated sum or guaranteed maximum could prove to be excessive.

Moreover, a stipulated sum or guaranteed maximum arrangement doesn't insulate a project against cost overruns. The project development cost can be further increased materially by delays in the work, unforeseen site conditions, change orders and many other circumstances.

A landowner who insists that the tenant-developer execute a stipulated sum or guaranteed maximum construction contract might take one step further and bargain for a requirement that the tenant-developer obtain a performance bond and payment bond with respect to the contract from a financially secure surety company.

Performance bonds are essentially limited guaranties by deep-pocketed surety companies that the principal obligor (the contractor) will live up to his obligations under a construction contract. A performance bond enables a developer to look to the surety company in case the general contractor fails to comply with his obligations pursuant to the construction contract.

However, a performance bond is no panacea for a subordinated ground lease landlord, and it is *not* an insurance policy. The obligations of the surety depend partly on the performance by the developer of his obligations (principally the obligation to pay the contractor) under the construction contract. Sureties also limit their liability by a fixed amount or "penal sum," which is usually the same amount as the contract price under the construction contract.

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Moreover, a subordinated ground lease landlord isn't the beneficiary of a performance bond. The bond is for the benefit of the tenant-developer.

What a landowner can expect to get out of a performance bond is the comfort that the tenant-developer will have additional muscle to deal with the kind of trouble that arises daily in the course of construction.

A payment bond (which usually accompanies a performance bond) assures *subcontractors* that the general contractor will pay *them*. A payment bond helps a tenant-developer directly and a landowner indirectly in that it encourages subcontractors to bid. In that respect, you might see a payment bond as a way to keep the bidding for subcontracts competitive. That, in turn, may help keep the construction contract price low. A subordinated ground lease landlord doesn't get much else out of a payment bond. But it can be helpful in that a subcontractor who is actually paid by a surety is not a potential source of trouble to a landowner.

The best way to protect a landowner against the problems he might encounter as a result of the tenant-developer's failure to pay for the construction cost is to require the tenant-developer to provide a meaningful personal guarantee that the construction will be completed and that the cost of construction will be paid. If the landowner is not completely comfortable with the financial condition of the tenant-developer, he should ask for third party guarantees or other methods of enhancing the tenant-developer's credit.

#### **[f]—Quality of Construction.**

A subordinated ground lease should require construction to conform to the plans and specifications that are adopted in accordance with the provisions of the lease.

In addition, the tenant-developer should be required to construct the buildings and other improvements in a good and workmanlike manner and in accordance with good construction practices. Construction should conform to all applicable requirements of governmental bodies and the insurance companies with which the tenant is required to insure the building.

To avoid disputes with neighboring landowners, the tenant-developer should be required to take reasonable steps to control dust, rubble and foul odors.

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To avoid personal injury claims, the tenant-developer should be required to take reasonable safety precautions, carry liability insurance, and extend the liability insurance coverage to the landowner.

#### **[g]—The Heartburn of Construction.**

If you're a landowner or a lawyer about to represent a landowner ready to execute a subordinated ground lease, this stuff has probably been frightening to you. But don't cry. You're not alone with your fears; the construction process is probably more frightening to developers and the people who represent them. To make the construction process work, they routinely risk their personal fortunes and provide personal guaranties to construction lenders.

Construction seldom runs smoothly, and disputes between developers and contractors and between contractors and subcontractors are common. Keeping subcontractors to a timetable is a difficult job at best. Quality control and making sure that what the subcontractors do conforms to the plans and specifications and legal requirements requires a developer to have an experienced and effective construction management team, a well developed upper body, and a case of Pepto Bismol.

Landowners aren't in a position to select construction managers or architects, their upper bodies are often worn and flabby, and they are not qualified to supervise construction personally.

Consequently, after a landowner executes an accommodation mortgage, until the construction is finished, the landowner may be subject to risks that extend beyond anything that can be limited by ground lease covenants.

I would have liked to have ended this Chapter on a note of optimism, but I can't. As I searched for some harmonious chord, I conjured visions of plans and specifications that contain no provision for heating or air conditioning, construction contractors who refuse to pay subcontractors for no good reason, jurisdictional strikes, incompetent supervision, football pools among the skilled tradesmen, fraudulent certifications, and organized theft of materials.

If you're looking for euphoria, maybe you should become a negligence lawyer.