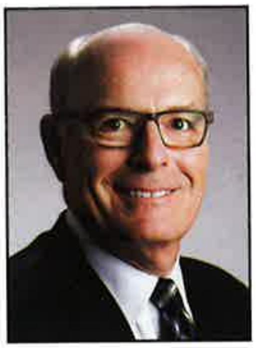

GROUND LEASE FUNDAMENTALS

By Tom L. DeVine and Andrea Austin

Using a ground lease in a hotel development can offer a more flexible arrangement than standard fee simple development.

This gives the parties greater ability to achieve short- and long-term objectives in a variety of development contexts. Yet ground leases differ substantially from other types of commercial leases, such as leases for space in a shopping center or office building, and understanding key differences—such as the longer length of ground leases and the typical inclusion of more rigorous financing provisions—and their impacts is essential.

What is a ground lease?
Ground leases are long-term leases of unimproved land where the property's expenses are paid by the tenant during the lease term and which allow the tenant to finance construction of the improvements on the land for its intended use. A typical ground lease term is 35-50 years or more, and tenants often seek multiple extension options of 10 years or more. Ground leases are not only leases in the traditional sense, but are also financing instruments. During the term of the lease, they sever ownership of the land from ownership of the improvements.

Why use a ground lease?
Among the reasons a landowner may lease rather than sell an unimproved parcel of land may be a desire to participate in the land value's expected appreciation over the lease term due to the parcel's development, and to pass that appreciated value to a future generation. Ground leases also avoid recognition of gain a landlord might otherwise realize if the land were sold: no immediate income tax consequence arises for a landlord entering into a ground lease until rental income is derived. Moreover, landlords may wish to retain control over the development and permitted uses of the land, particularly where a landlord owns adjoining property and wishes the ground lease parcel to be developed for a use compatible with the adjoining parcel.

From the developer's perspective, a primary motive for seeking a ground lease is to avoid having to obtain the cash for the purchase of the land from its own resources, from investors or from a lender. Ground leases may also confer a tax incentive because rent payments under a ground lease are fully deductible for federal income tax purposes, while the principal component of debt service for borrowed purchase money is not deductible. Willingness to enter into a ground lease may also give a developer access to prime sites not available for purchase.

Financeable Ground Leases
For most tenants a ground lease development is feasible only if the tenant can mortgage its leasehold interest to obtain favorable lease financing. To be financeable a ground lease must contain certain key provisions. Because lenders receive only limited rights in the property under a ground lease mortgage, ground leases present unique challenges to lenders. Ideally for tenants, the landlord agrees to subordinate its rights in the land to the rights of the tenant's lender—but these subordinated ground leases are less common and often carry higher rents to offset the additional risks undertaken by the landlord.

More common are unsubordinated ground leases whereby the landlord's mortgagee, if any, maintains a priority interest in the land and the leasehold mortgagee has a priority interest in the improvements. The ground lease must contemplate these competing interests and contain provisions for non-disturbance of the tenant's rights in the event of a landlord default under its loan. Adequate notice and cure provisions are also critical to a tenant's lender in case the tenant defaults under the ground lease.

Rights to assign or sublease the leased premises are another key component of a financeable ground lease. A freely assignable leasehold interest following a foreclosure is clearly the most desirable for tenants and their lenders. Landlords nonetheless will wish to maintain some control over the assignment or subletting of the lease – certainly regarding the creditworthiness of an assignee or sublessee and very likely, in the case of a hotel operator, to ensure that the hotel continues to operate as a similar class hotel under a comparable flag.

Ground leases should also require leasehold mortgagees be added as co-insureds or additional insureds on any casualty insurance policy for the improvements. While sharing the insurance proceeds after a casualty event will be a point of negotiation with the landlord, both landlord and tenant interests are generally best served if the improvements are rebuilt, provided sufficient time remains on the lease. The ability to apply insurance proceeds to rebuilding improvements assures the leasehold lender that the full value of its collateral can be maintained.

Recordation of the ground lease or a memorandum of ground lease is another important aspect of drafting a financeable ground lease, and fortunately is seldom problematic for either tenants or landlords.

Rental rates and covenants

Ground leases invariably contain rent escalation clauses that increase the rent at predetermined intervals. Whatever formula is used for determining adjustable rents, the landlord will want to ensure that the rents for subsequent periods are not less than the rents for preceding portions of the lease term and tenants will argue that increases should be subject to caps or maximum period-to-period increases. Due to the potential impacts on debt service coverage ratio and other financial covenants, lenders will be keenly interested in the rent escalation provisions in ground leases.

Although lease covenants vary, tenants should expect use restrictions but should resist landlord attempts to impose continuous operation covenants. During a 35- or 50-year lease a hotel owner may require rebranding or major refurbishment that interrupts operations. Tenants (and leasehold lenders) may agree to provisions allowing the landlord to terminate the lease if suspension of operations exceeds a specified period, but such a period should contemplate the tenant's need to rebrand and refurbish the improvements.

Conclusion

Ground leases have become an important part of developing hotel properties. Unlike fee simple transactions, the landlord, tenant, and each of their lenders have different, often competing, perspectives arising from the unique duration and terms of a ground lease, that must be protected. A properly drafted ground lease will include provisions that deftly balance all of these interests.

DeVine and Austin are partner and associate, respectively, at Holland & Hart, LLP. They can be reached at 303.295.8173, tldevine@HollandHart.com or aaustin@HollandHart.com.