The ground lease is the answer to many structural problems in the acquisition, assemblage and development of commercial real estate. A property owner may want to retain the fee for the perceived residual value as part of an estate planning exercise of creating a bond type fixed return asset and a more entrepreneurial asset (the leasehold). A ground lease can be used to facilitate development if a parcel cannot be subdivided but multiple uses are possible or where governmental restrictions make sale of the fee impractical for these and numerous other reasons. Consequently, the ground lease is a very popular and useful device for land development. However, the ground lease is also consistently the cause of more trouble and pain when it's time to finance that real estate than any other commonly used acquisition and development deal feature. Although the mere phrase “ground lease” can elicit a shudder from any finance lawyer, there is nothing inherently problematic in a ground lease and, with good planning, most ground lease horror stories can be avoided.

Financability problems associated with the design of ground leases are exacerbated in transactions in which the loan to be secured by the ground lease is destined for securitization. This is not because of anything inherently different in a securitized structure, but because the securitization market has developed the most specific and consistently enforced rules for the structural elements of commercial loans, including ground leases. Consequently, in general what is true in a commercial mortgage-backed securitization structure (“CMBS”, or a “CMBS Structure”) should also be true for prudent portfolio lending. In the final analysis, the CMBS rules are really nothing more than rational underwriting rules developed and enforced by the four major rating agencies to analyze real estate credit risk. Many portfolio lenders have always approached ground leases in essentially the manner embraced by the rating agencies and now, even more, underwrite to CMBS standards (more or less) to protect the value of their loans that may in the future be sold into the capital markets. As the structural discipline of the capital markets rapidly overspreads (infests?) the portfolio market, counsel should generally endeavor to meet capital market standards (or at least be mindful of those standards) whenever creating or negotiating a leasehold estate.

1 If the landlord subjects its fee to the mortgage financing, the quality of the leasehold estate becomes relatively unimportant. This article focuses on the misnamed “unsubordinated fee” ground lease in which the ground lease financing does not create a lien on the fee estate. The “unsubordinated fee” is misnamed because a fee interest cannot be “subordinated” to a mortgage; rather, it is merely subjected to the lien of the mortgage.

A ground lease need not merely cover “ground” (i.e., an unimproved parcel of land); rather, what’s generally known as a ground leasehold estate can include land and improvements, a condominium unit or even an air rights parcel. In a ground lease financing, the landlord holds fee title to the land and, in some cases, the buildings and improvements (collectively, the “property”), and the borrower leases the property from the landlord. The landlord does not subject its fee interest to the lender’s mortgage lien (once again, if the landlord permits its interest to be mortgaged, the transaction is really a simple fee mortgage).

Fundamentally, what makes a lease a ground lease is the long term and durable nature of the estate creating a temporal segment of the total bundle of rights constituting real property that can support secured long term financing. The tenant’s interest under a ground lease is recognized as an interest in real property throughout the United States and, accordingly, the title insurance industry will insure it. A leasehold interest can be mortgaged much the same as a fee interest. However, unlike a fee interest, it is, in large measure, a creature of the bilateral contract that forms it. Consequently, the terms and conditions of that document can make or break the financeability of the estate.

If a property owner and a prospective occupier sign an instrument that identifies the parties, states the term and the consideration to be paid for possession, it is a lease. If the term is long enough and, where required by local law, it is recorded or a memorandum of its existence is recorded, it is a ground lease. That document can be, and sometimes is, two pages long.

Not only is that two page document a ground lease, but it can support mortgage financing. Although such a brief document is not prudently financable in any case, it is not financable in the capital markets. It is not financable because the secured lender will have no assurance that the leasehold estate will continue for the term of the loan, leaving the lender unsecured, nor can the lender be certain that it can effectively protect the value of the collateral. By way of example, such a lease may expire by its terms before the maturity of the loan or so soon thereafter, thereby making the tenant’s ability to refinance difficult or impossible. The tenant’s conduct may entitle the landlord to terminate the lease before its contractual expiration date. Where the lease is silent, the tenant’s ability to mortgage or assign its leasehold estate may be in doubt, as may be tenant’s right to casualty and condemnation proceeds to protect the value of income-producing improvements.

The criteria of the capital markets (as, in large measure, articulated by the rating agencies) address each of these concerns and meeting these criteria will create a financable ground lease.

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3 A leasehold loan policy will provide on Schedule A the names of the owners of the fee estate and the leasehold estate. Schedule A will also make clear that the estate or interest in the land that is encumbered by the insured mortgage is the leasehold estate. Section 1(h) of the Conditions and Stipulations of the leasehold loan policy often defines the phrase “leasehold estate” as “the right of possession for the term or terms described in Schedule A hereof subject to any provisions contained in the Lease which limit the right of possession.”

4 Although, God knows, people continue to try. It can also be made financable as described below.
The ground lease should have the following provisions or characteristics to be financable:

**TERM**

As a general matter, the lease term should extend well beyond the maturity date of the loan to ensure, among other things, that the borrower will have a good chance to refinance the loan at maturity. Although the rating agencies have differing and not always clear views on the length of the term, S&P requires that the term of the ground lease extend 20 years beyond the final maturity date of the loan, and DCR requires that the ground lease extend 10 years beyond the amortization period of the loan. To date, Moody’s and Fitch have not published any criteria regarding this issue; however, based on discussions with analysts at both of these rating agencies and a review of the required ground lease representations and warranties, it appears that both Moody’s and Fitch will follow DCR’s 10 years after the amortization period rule. Remember that the maturity of rated securities is usually well beyond the term of the underlying loans. Consequently, the criteria of each of the four rating agencies is not that dissimilar, but prudent counsel will endeavor to meet both the 20 year and 10 year tests.

Options to extend vested in the tenant can be counted, but the lease should be structured so that the options can be exercised in advance or the lender has the right to exercise such extension on behalf of the tenant. The lease should also contain a provision that requires the landlord to deliver notice to the lender if the tenant fails to exercise the renewal option and that grants the lender an additional period of time to exercise the option. The rating agencies will require such advance exercise or evidence of the lender’s ability to extend so that there is no risk of early expiration from inattendance to exercise dates.

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5 S&P is the only rating agency that has published criteria regarding ground leases. Although the other agencies have not followed suit, after discussions with analysts at each of the agencies and, in some cases, with agencies’ counsel, it appears that each of the agencies’ internal criteria regarding ground leases is substantially similar to that of S&P. This consistency is reflected by the relatively uniform reaction of the rating agencies to depositor representations and warranties on ground leases.

6 See Standard & Poor’s Structured Finance Ratings Real Estate Finance Legal and Structured Finance Issues in Commercial Mortgage Securities, page 41. It should be noted that although this criteria book states that the term should be 10 years beyond the final maturity date, S&P recently changed its criteria to provide that the ground lease term extend 20 years beyond the final maturity date. To date, S&P is applying the new 20 year rule; however, S&P has not formally published new criteria on this point.

7 See Duff & Phelps Credit Rating Co. CMBS Legal Issues Latest Legal Issues Regarding Commercial Mortgage Loans (Sept. 1999). In this article, DCR states that “[w]hile ERISA requires that a ground lease term extend not less than 10 years beyond the loan term, DCR believes not less than 10 years beyond the amortization term is more prudent. Although the industry has focused more on the ERISA requirement, DCR contends that, particularly with respect to balloon loans, a longer term would be highly advisable.”
The rationale behind the term requirement is straightforward. The length of time must be sufficient to amortize the loan and permit refinancing. The analysis is based on the amortization schedule (or a hypothetical amortization schedule, if the loan is interest only) because if the loan defaults, the property must be refinancelable or produce sufficient revenue to retire the debt. Of course, the problem with term criteria from the perspective of tenant’s counsel is that the analysis occurs as of when a loan is securitized and not when the lease is prepared. Suffice it to say that the longer the term the more likely there will be sufficient time left when rating criteria are applied. Consequently, whenever an opportunity presents itself to extend the term or procure options, that opportunity should be taken.

**Notice of Default or Right to Cure**

In the lease or in a landlord estoppel (discussed below), the landlord must agree to provide the lender with notice of a borrower default and with a right to cure. Notice must be in writing and the cure right must be meaningful, which means that the period of time accorded the lender must be reasonably adequate to effect a cure. A 30 day cure period for monetary defaults and 30 days plus a “diligently pursuing” extension for non-monetary defaults is customary. Although most landlords will try to limit the non-monetary cure period, care should be taken to give the lender a sufficient period of time to cure such defaults, which period must include time to foreclose and take possession, if necessary, to effectuate the cure. Events of default that are inherently non-curabe (e.g., breach of a representation) can be problematic but overcome through the lender’s right to enter into a new lease with the landlord; in the unlikely event the tenant’s non-curable default results in the termination of the lease.

**New Lease Option**

The lender must have a right to obtain a new lease from the landlord on the terms of the old lease if the old lease is terminated for any reason. A ground lease might terminate because of (i) an uncurable default; (ii) borrower’s failure to cure combined with lender’s failure to effectively exercise its cure rights, or (iii) the bankruptcy of the tenant and rejection of the lease in its bankruptcy proceeding. If the lease is terminated for any reason, the lender must have a right under the ground lease or in a separate agreement to enter into a new lease with the landlord; otherwise, once the lease terminates, all rights associated with the leasehold mortgage are extinguished. This right is one of the most important criteria for securitized lending and

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8 See the “New Lease Option” section below for further discussion.

9 This last point perhaps deserves a short digression. Under 11 U.S.C. §365 of the U.S. Bankruptcy Code (“Code”), the debtor in possession or trustee can reject a lease if rejection is in the best interest of the estate. For most ground leases the debtor/trustee is likely to have an incentive to affirm the lease, as the termination of the lease will end the debtor/trustee’s ability to conduct business at the property. Nonetheless, a debtor with little equity to protect in a property may endeavor to use the rejection right in a negotiation with its lender, leaving the lender’s collateral position in a tenuous state.

10 See In re Gillis, 92 B.R. 461, 465 (Bankr.D.Haw. 1988) (“Gillis”), which held that “[t]he Lease was deemed rejected pursuant to 11 U.S.C. §365(d)(4), and the effect of this rejection is to terminate the Lease. When the Lease
one of the most often overlooked provisions in the drafting of leases intended to be mortgaged. The absence of a new lease provision will render the ground lease unfinancable in the capital markets.

Many ground leases are silent regarding the lender’s right to obtain a new, direct lease. In contrast, some ground leases contain a provision that essentially provides that “upon the termination” of the ground lease, the lessor will enter into a new lease with the lender. Although such a provision appears to protect the lender, it is not clear whether the phrase “upon termination” incorporates a bankruptcy situation. Because the bankruptcy of a landlord or a tenant under a ground lease entitles the bankrupt entity to assume (i.e., continue) or to reject (i.e., terminate) the ground lease, it is imperative that care be taken to draft express language regarding a bankruptcy into any such “upon termination” provision.

Regardless of whether the ground lease is silent regarding a new, direct lease or contains an “upon termination” provision, it is possible that liens that were subordinate to the lender’s leasehold mortgage will gain priority during the time gap between the termination of the original lease and the inception of the new, direct lease. Consequently, when drafting the new, direct lease provision, care should be taken to ensure that any encumbrances made by the ground lessor are subordinated to the ground lease and to the lender’s right to enter into a new, direct lease.12

Although no amount of drafting is guaranteed to override a judicial interpretation of the Code, following is a suggested provision designed to address the issues discussed above:

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is terminated, the [lender’s] security interest was completely extinguished, since there was no remaining leasehold interest to which the security interest could attach.” See also In re Hawaii Dimensions, Inc., 39 B.R. 606 (Bankr. D. Haw.), aff’d 47 B.R. 425, 426 (D. Haw. 1984). But see Matter of Austin Development Co., 19 F.3d 1077, 1082 (5th Cir.), cert denied sub. nom Sowashee Venture v. EB, Inc., 513 U.S. 874 (1994) (“Austin”). Contrary to the Gillis decision, the Austin court held that a rejection of the lease under the Code does not terminate the ground lease; rather, a breach occurs and a creditor can assert a claim for damages for such breach outside of the bankruptcy court. According to the Austin court “[i]f, … deemed rejection of a lease or executory contract automatically brings about its termination, it is peculiar that the most adverse consequences of that statutory interpretation are reserved not for the lessor or lessee -- either of which may be the party opposite the debtor -- but for the third-party mortgagee whose rights have been held forfeited by operation of law. This result has no policy rationale … [and] is a capricious result that makes no bankruptcy sense.”

1 Under the Code, if the landlord becomes bankrupt and rejects the ground lease, the tenant has the option to remain in possession of the premises for the balance of the term (which includes any renewal options) or to treat the lease as though it has been terminated. Although it is critical that a lender preserve the lien of its leasehold mortgage by exercising control over the tenant’s ability to terminate the ground lease on the bankruptcy of the landlord, a discussion of the landlord’s bankruptcy and its effect on the leasehold mortgage goes beyond the scope of this Article.

12 See generally Levitan, Leasehold Mortgage Financing: Reliance on the “New Lease” Provision, 15 Real Prop. Prob. & Tr. J. 413 (1980); and Collier Real Estate Transactions and the Bankruptcy Code, ¶ 2.01[8] (1998). In addition, if the lender permits the tenant to obtain any additional financing, care should also be taken to ensure the continued priority of the leasehold mortgage in the case of a new, direct lease.
“If the lease [insert description of the lease (“Lease”)] is rejected in connection with a bankruptcy proceeding by Tenant, a trustee in a bankruptcy or such other party to such proceeding on behalf of Tenant, as applicable, such rejection shall be deemed an assignment by Tenant to Lender of the Property and all of Tenant’s right, title and interest in and to the Lease and the Lease shall not terminate. In connection therewith, Lender shall have all of the right, title and interest of the Tenant as if such bankruptcy proceeding has not occurred, unless Lender shall reject such deemed assignment by notice in writing to Landlord within thirty (30) days following rejection of the Lease by Tenant, the trustee in bankruptcy or such other party to such proceeding, as applicable. If any court of competent jurisdiction shall determine that, notwithstanding the terms of the preceding sentences, the Lease shall have been terminated as a result of a rejection by Tenant, the trustee in the bankruptcy or such other party to such proceeding, as applicable, Landlord shall, on Lender’s written election, promptly enter into a new, direct lease with Lender or its designee for the Property on the same terms and conditions as those contained in the Lease (“New Lease”), it being the intention of the parties to preserve the Lease and the leasehold estate created by the Lease for the benefit of Lender without interruption. The New Lease shall be superior to all rights, liens and interests granted at any time on the fee interest in the Property and to all rights, liens and interests intervening between the date of the Lease and the granting of the New Lease, and shall be free of any and all rights of Tenant under the Lease. If Lender designates Tenant to enter into the New Lease in accordance with the terms hereof, Tenant and Landlord acknowledge and agree that Lender shall have the right to encumber the New Lease and the estate created thereby with a deed of trust or a mortgage (as the case may be) on the same terms and conditions, and with the same first lien priority as the Mortgage, it being the intention of the parties to preserve the priority of the Mortgage, the New Lease and the leasehold estate created by the New Lease for the benefit of Lender without interruption.”

13 Although taking such an assignment would arguably place the lender in a better position because it would preclude the landlord from bringing a claim for damages arising from the rejection, it is questionable whether such an assignment (which is an agreement between the borrower and the lender, not the bankruptcy trustee) would, in fact, prohibit or otherwise deter a bankruptcy trustee from rejecting the lease as it is so permitted to under §365(a) of the Code. Consequently, this sample language is designed to protect against the possibility that a bankruptcy trustee will reject the ground lease notwithstanding the fact that the tenant assigned its rights thereunder to the lender.
ASSIGNMENT AND SUBLETTING

The leasehold estate must be assignable and mortgageable without any limitations or restrictions. A specific grant of the right to mortgage is important even if the lease includes a general assignment clause. Moreover, the lease cannot merely permit mortgage financing but must also permit assignment because the lender needs the right to sell the property in the event of a foreclosure. Negotiating this right on behalf of the lender can be problematic as this is a point on which achieving financability may be perceived by the landlord as having substantive adverse consequences for it and, as such, disputes over this issue are common.

To some extent, the landlord has a legitimate interest in the identity of the tenant as the tenant must successfully operate the property to pay the ground rent. Presumably, some tenants will be more successful at this than others. However, in most cases, the lease payments are typically fixed and relatively low in comparison to the value of the improved property, thereby rendering the tenant’s competency as an operator to be less of a critical issue. Moreover, the landlord has little likelihood of reacquiring possession for many years (and, in most cases, decades) and therefore a relatively attenuated interest in the quality of the tenant’s maintenance of the property’s improvements. For these reasons, the tenant’s need to achieve mortgageability and assignability ought to outweigh the landlord’s interest in restricting assignment.

Limitations that require a mortgagee to be an institution (e.g., banks, savings institutions, insurance companies or other business entities with a minimum net worth) were less problematic before capital market real estate lending. However, with the advent of the CMBS market, such a restriction will raise real questions as to the qualification of a CMBS trustee and, as such, should be avoided or, at minimum, be expanded to expressly include a CMBS trustee.

Provisions according the landlord “reasonable” approval rights over the assignee should be avoided if at all possible, even if such consent cannot be unreasonably withheld, conditioned or delayed. Any dispute regarding reasonableness could substantially delay the lender’s ability to realize on the collateral. As an example, prior to a foreclosure sale, the lender would arguably need to pre-qualify all prospective bidders with the landlord. Given a lender’s desire to have the largest number of potential bidders as possible at such a sale, obtaining this consent would either diminish the lender’s available pool or substantially delay the lender’s ability to foreclose, thereby adversely affecting the value of the collateral.

The tenant should also be entitled to sublet the property without the consent of the landlord. Each sublease should expressly provide that it is subordinate to the ground lease, the leasehold mortgage and any new, direct lease entered into between the landlord and the lender. The landlord should agree to enter into a reasonable non-disturbance agreement with the subtenants. In connection with any subletting right, the subtenants should be required to attorn to the lender if the lender forecloses and becomes the owner of the leasehold estate.

CASUALTY, INSURANCE AND CONDEMNATION PROCEEDINGS
Conflicts over the relative interests of the landlord, the tenant and the lender in casualty and condemnation proceedings are an age-old problem. Although there are plenty of traps for the unwary here, simply knowing the rules doesn’t get the tenant home. Once again, this conflict is an issue of real economic significance to all the parties. These are the rules. First, neither the landlord nor the tenant may terminate the ground lease for damage or destruction. Second, the insurance policies required to be maintained pursuant to the lease should name the lender as an additional insured and loss payee/mortgagee. Third, neither the landlord nor the tenant may cancel or amend any insurance policies without the lender’s consent. Fourth, the lender must “participate in settlement” and “control” the receipt of the insurance proceeds and condemnation awards, as applicable. Fifth, any casualty proceeds or condemnation awards must be available to reconstruct the property or to repay the loan.

The first requirement that no cancellation of the lease is triggered by a casualty or condemnation is normally not controversial. The parties understand the ground lease is a long-term estate and, as long as rent is paid, there is plenty of time to restore and for the tenant to recoup any further investment. The second requirement that the lender become an additional insured and loss payee/mortgagee is easy to comply with and is industry standard. The third and fourth restrictions on the parties’ ability to amend any insurance policy without the lender’s consent and the lender’s right to participate in any the settlement of insurance proceeds and condemnation awards, as applicable, are also rarely controversial. These restrictions are no different from any mortgage financing, and the landlord’s interests are well aligned with those of the lender. Generally, the landlord wants the property restored and the proceeds protected from misappropriation.

Control over proceeds ought not be controversial, but many leases require proceeds to be held by an independent bank or financial institution rather than the lender. This requirement may be acceptable provided that the tenant can offer the lender assurance that (x) the proceeds will continue to constitute a portion of the lender’s collateral and the lender will have a first priority perfected security interest in such proceeds, (y) the proceeds will be disbursed in accordance with the mortgage, and (z) the designated institution has a long term

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14 It should be noted, however, that it is permissible for the lease to provide for termination on a complete condemnation. See discussion below in this “Casualty, Insurance and Condemnation” section regarding the allocation of the condemnation award. There have been some cases in CMBS structures where the ground lease terminated in certain situations. In those circumstances, some, if not all, of the other rating agencies have required the tenants to obtain, for the benefit of the lender, lease enhancement policies. By way of example, Chubb Custom Insurance Company has a loss of rents insurance policy that is designed to cover losses of rent resulting from the termination of a lease (or partial abatement of rent) in the event of a casualty or condemnation. In the case of a lease termination (rather than a partial abatement), the loss of rents typically covers the unamortized balance of the first mortgage loan on the date of the termination. As discussed below in the “External Credit Support” section, obtaining such a lease enhancement policy is one way for the parties to resolve a problem outside the four corners of the lease.

15 Id.
debt rating of at least “AA” or its equivalent. If the landlord is merely the owner of the unimproved land, the landlord’s interest is usually limited to ensuring the property is rebuilt to protect its interest in the economic performance of the property. From such a perspective, the landlord may insist that proceeds always be used to restore. If the landlord owns a residual interest in the improvements, it may feel a portion of the proceeds should be used to compensate the landlord for its residual interest.

A condemnation presents a more complicated situation because the parties need to apportion the amount of the condemnation award among the tenant/lender and the landlord and, inevitably, valuing the parties’ respective interests will create some conflict. The ground lease or the landlord estoppel (discussed below) should provide that on the occurrence of a total condemnation, the tenant/lender should receive first the value of the leasehold estate and the value of the improvements up to the amount of the outstanding principal amount of the debt, together with interest thereon and any other unpaid sums, and, thereafter, the landlord should receive the value of the unimproved land and possibly the value of the reversionary interest in the improvements. On the occurrence of a partial condemnation, the parties will need to determine whether the property can, in fact, be restored and, if not, the award should be divided amongst the parties in roughly the same manner described above.

A structure that absolutely requires that proceeds be used to reconstruct (as opposed to providing the lender with the option to pay down the debt) may be acceptable, as this is the preferred result from the lender’s perspective in most instances. Under capital market loan documentation, there is a bias towards using proceeds to reconstruct provided reconstruction is viable. Nonetheless, if restoration is not possible for legal or physical reasons, the proceeds must pay down the debt. It is more troublesome if the landlord insists on a share of proceeds. If the landlord is entitled to a share of proceeds from the first dollar, the “gap” resulting from landlord’s share must be filled. Although this situation is uncommon, it may be filled with certain types of insurance policies, letters of credit or other high quality sources of liquidity.

**NO CANCELLATION**

The lease cannot be surrendered, cancelled, amended or modified without the consent of the lender. The lease should provide that any such cancellation, surrender,

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16 The “AA” or its equivalent rating is analogous to the requirement that the trustee in a CMBS structure have a rating no lower than one rating below the highest rated certificate.

17 The real economic difference between owning just the land or land and improvements is in fact slight, as the useful life of most improvements is often less than the term of the lease. Some landlords, however, see, or insist they see, a distinction.

18 If the casualty or taking occurs very close to the end of the term of the loan (i.e., 3 to 6 months is common), the lender usually has the right to use the proceeds to retire the debt.

19 See the “External Credit Support” section below for further discussion.
amendment or modification will not be effective without the consent of the lender. These provisions stand to reason and should not be difficult to negotiate.

**BURDENSOME TENANT OBLIGATIONS**

Most ground leases are structurally simple and require the tenant to take full responsibility for maintenance of the property, payment of taxes and assessments to the applicable governmental authority and payment of fixed ground rent to the landlord. As discussed above, if the lease obligates the tenant to the landlord in more burdensome ways or requires the tenant to perform an unusual or unique obligation that would be difficult or impossible for the lender to replicate, financability may be impaired. For instance, a requirement that the property continue to be operated as a specifically named retailer will impair the value of the property as collateral. Similarly, an operating covenant can be problematic as the lender cannot assure the property will be continuously operated after a default. Indeed, given the long-term nature of the ground lease estate, any restriction on legal use is problematic. Although some level of restriction may not render a lease entirely unfinancable, the lender will want these restrictions eliminated as it will undoubtedly affect value.

**NO MERGER**

The ground lease or the landlord estoppel (discussed below) should contain a provision stating that if the tenant acquires the title to the fee estate, there will not be a merger of the fee and the leasehold estates. Otherwise, because a property owner cannot lease the property from itself, the fee and leasehold estate would merge, thereby possibly resulting in a termination of the mortgage.

**LANDLORD ESTOPPELS**

Rarely is a ground lease executed simultaneously with the closing of the financing and, consequently, rarely are all the lender issues adequately addressed in the lease. In fact, as often as not, ground leases are well-seasoned when financing is contemplated and it’s relatively common to find leases that comprehensively fail the test of financeability, whether because of uneven bargaining power amongst the parties at inception, or lack of sophistication.

These and any other problems that may exist in the ground lease can be fixed through the well-crafted landlord estoppel. An estoppel is a document in which the landlord, for the benefit of the lender, gives assurances on various matters about the lease and the performance of the parties. In some cases the estoppel also can be used to amend the lease.

Typical assurances given by landlord in the estoppel include the following:

- a description of the premises;
- a statement of the commencement and expiration dates of the lease (including any renewal terms);
• a statement of the base rent, any additional rent, all pass-throughs, and all
other sums payable by the tenant to the landlord;

• a statement of the amount of any escrows or deposits held by the landlord
under the lease;

• a statement recognizing and, if applicable, consenting to the lender;

• a confirmation that the lease is in full force and effect and contains the
complete agreement between the parties;

• a confirmation that the lease is not modified or, if modified, a detailed
description of such modifications;

• a confirmation that the tenant is not in default under the lease and rent is
current (if there is a default, it should be specifically described);

• a confirmation that the tenant has not paid more than one (1) month’s rent
in advance;

• a confirmation that the landlord is not in default under the lease, with a
description of any defaults that might exist;

• a confirmation that neither the landlord nor the tenant has assigned the
lease or sublet the lease (with any exceptions described in detail);

• a confirmation that there are no options, rights of first refusal, rights to
terminate, renew, or extend the lease other than as described in the lease
agreement (with the description of any such exogenous rights);

• a confirmation that the landlord has no knowledge of any offsets or
defenses to payment of its rent, nor any basis for withholding rent against
landlord and the landlord has no knowledge of any claims by others
against the borrower relating to the property;

• a confirmation that the landlord has not assigned, conveyed, transferred or
encumbered or mortgaged its interest in the lease or the lease property and
there are no encumbrances on the landlord’s fee interest;

• a confirmation that the landlord has not received any written notice of any
pending eminent domain proceedings or governmental actions or any
judicial actions against the landlord’s interests in the property; and
a confirmation that the landlord has not received notice that it is in violation of any governmental rules and regulations applicable to its interests in the property.

As mentioned above, the landlord estoppel can also be used to cure significant problems with the underlying lease. It is not at all unusual for a landlord estoppel to effectively amend or restate portions of the underlying lease for the benefit of the lender. By way of example, if the lease provides that insurance proceeds and condemnation awards will be handled in a way that conflicts with the mortgage, the lender should negotiate the appropriate changes through the landlord estoppel. Where substantive changes to the lease are achieved through the landlord estoppel, the landlord estoppel should be recorded in the land records or the existence and the substance of the estoppel should be reflected in an amended memorandum of lease.

Of course, it is better practice when confronted with a non-conforming ground lease to require the tenant and landlord to amend and restate the lease. However, there appears to be a psychological dynamic in many cases that renders the estoppel a preferable solution than the restated lease. Consequently, if the business dynamics between the parties will not permit such a housecleaning solution, then the landlord estoppel is sufficient.

Finally, it is important to the lender that it have a right to obtain an updated estoppel periodically. For example, the lender will need to obtain a new estoppel at the point when the loan is securitized. Most landlords argue that furnishing such estoppels is time consuming and costly and, as such, will try to limit the number of times that it will be required to furnish an estoppel. Limiting the number of times the lender will be required to deliver such an estoppel is entirely reasonable provided that the lender is assured that it can obtain one at any time when it is requested by a rating agency, a participant or an assignee.

LENDER, SUCCESSORS AND ASSIGNS

Where substantive changes to the underlying lease will be carried out through the landlord estoppel, it is necessary to ensure that these changes will be enforceable by the lender and its successors and assigns and, in effect, become a permanent part of the underlying lease. It does the lender little good if changes are made benefiting merely the lender, but will not be available to ameliorate existing structural problems in the lease when the lender sells, participates or securitizes the loan or otherwise when, if at all, the lender enforces its remedies, acquires the property and attempts to sell the property in reduction of the debt.

EXTERNAL CREDIT SUPPORT

In some cases, the ground lease will have problems that cannot be resolved contractually. A landlord, for good reasons or ill, will simply not agree to any changes in the form of the underlying ground lease. In such a case, it is conceivable to look outside the four corners of the lease to fix the problem. One example would be a provision in the ground lease...
that permits the lease to terminate on the occurrence of a casualty or condemnation. As discussed above in footnote 14, it is possible to obtain a lease enhancement policy to cover losses resulting from such a termination event. As discussed above, another example of such a problem might be a provision in the ground lease that gives a landlord the right to collect 25% of any award from the total taking of the property. In such a situation, it may be possible to obtain an insurance policy effectively insuring that the amount of proceeds payable for the tenant’s interest in the ground lease will be sufficient to pay off the total amount of the related debt. Regardless of the issue, any such policy must, of course, be viewed through the lens of the rating agencies’ approach to insurance coverage that will require, among other things, that the insurance company issuing the policy have a particular financial strength rating or claims paying ability, as applicable (“Required Rating”).

In situations where the company providing the insurance product does not have the Required Rating, S&P and some of the other rating agencies have permitted tenants to obtain a “cut-through endorsement,” which means that the tenant’s insurance company will enter into an agreement with a second insurance company that does, in fact, have the Required Rating. The agreement essentially provides that if the tenant’s insurer cannot meet its payment obligations under the policy, the party making a claim under the policy can “cut through” to the second insurance company that is obligated to make the requisite payment. Although the rating agencies do not have published criteria on this issue, it appears that not only are cut-through endorsements acceptable, but the rating agencies will allow the tenants to obtain such insurance coverage from a consortium of insurers if the insurance premiums escalate above a certain undefined threshold over the previous year. If the tenant does obtain such insurance through a consortium, it is advisable to consult with the rating agencies as to the required ratings for each member of the consortium.

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20 Although many of the rating agencies require that insurance companies issuing policies in a pool transaction have a “BBB” rating or its equivalent and insurance companies issuing policies in a stand-alone transaction must have a “AA” rating or its equivalent, the rating agencies may not apply that rule to such external credit support. Rather, the rating agencies will analyze such policies on a case by case basis in the context of the particular CMBS structure.
LANDLORD ENCUMBRANCE

It’s possible that the landlord may encumber its interest in the fee, distinct from the leasehold estate. The presence of a mortgage on the fee, if subordinate in right to the leasehold estate, while intuitively troubling, is not, in fact, necessarily a major problem for the financability of the ground lease. In fact, it is quite possible to maintain two separate and distinct financing structures for the same piece of physical property through the use of the ground lease. The landlord can finance the income stream from the ground lease in the same way landlords typically finance leasehold income. Provided the ground lease (and any subleases) is absolutely prior in right to the financing on the fee, the leasehold financing structure can be independently maintained. Note, however, that this mortgage subordination must include subordination to any modifications of the ground lease, subleases and to any new lease given to the lender after termination of the original of the ground lease and to any new lease given to the lender after termination of the original lease. This subordination must be automatic and the landlord cannot mortgage its fee without the lender’s consent that, if not expressly given or withheld, must give the lender sufficient control to impose absolute subordination. This structure can create complexities in negotiating landlord estoppels or otherwise changing the terms of the proposed lease to be financed, but these are problems that can be overcome in the course of good faith negotiation.

GROUND LEASE REPRESENTATIONS AND WARRANTIES

Ground leases are often long and complex. When loans secured by ground leases are included in a pool of loans to be rated by one or more of the rating agencies, the rating agency analysts cannot review each ground lease. If a loan secured by a ground lease is among the largest in a pool, the rating agencies may require counsel to prepare a detailed abstract of the lease. However, the primary and more likely tool the rating agencies (and investors) have for ensuring a ground lease meets criteria is the representations and warranties required to be made by the depositor and/or mortgage loan sellers in a CMBS transaction. Either through published criteria or market usage, each rating agency has developed a form of ground lease representation that will be required for the securitization. Though the four versions are quite similar, the S&P, DCR and Fitch versions are attached as Exhibit 1, 2 and 3, respectively.21

CONCLUSION

The ground lease creates a perfectly valid and financeable interest in real property. It is a flexible tool for the assemblage and financing of real property. To be financable, the estate must be of adequate duration, be durable, and give the lender its customary bundle of remedies, including control over casualty proceeds and condemnation awards. The

21 The rating agencies can always require additional representations and warranties and, as such, the representations and warranties identified on these exhibits is illustrative only.
capital markets are anecdotally known as a tough place to finance a ground lease. However, there’s nothing terribly distinct about the application of capital markets rules to the ground lease. In large measure, what distinguishes the capital markets from the portfolio lending market is only the rigor and consistency with which market standard underwriting rules are applied. The bad reputation that has attached to the leasehold estate in financing in general, and, in particular, in the capital markets, rises more from a lack of appreciation of the rules of financability than from the difficulty of meeting these criteria. Admittedly, the opportunities for mischief abound given the fact that the ground lease is often a long, bilateral agreement in which the parties are sometimes tempted to incorporate unique or unusual deal terms that break down when viewed through the lens of a prudent lender. However, there is nothing inherently inimicable to the interests of the landlord in the changes that are necessary to render a lease financable. Well intended parties, with the knowledge of basic rules of financability, should always be able to craft an acceptable lease.
EXHIBIT 1

With respect to any mortgage which is secured in whole or in part by the interest of a borrower as a lessee under a ground lease (the applicability of these representations and warranties will vary depending on whether or not the ground lessor’s fee interest is subordinated to the lien of the mortgage):

(i) **Fee Encumbered.** The mortgage loan is also secured by the related fee interest in the mortgaged property, and the fee interest is subject and subordinate of record to the mortgage, and the mortgage does not by its terms provide that it will be subordinated to the lien of any other mortgage or other lien upon such fee interest, and upon the occurrence of an event of default under the terms of the mortgage by the borrower, the mortgagee has the right to foreclose or otherwise exercise its rights with respect to the fee interest within a commercially reasonable time.

(ii) **Recording.** The ground lease or a memorandum thereof has been duly recorded, the ground lease permits the interest of the lessee thereunder to be encumbered by the related mortgage, and there has not been a material change in the terms of the ground lease since its recordation, with the exception of written instruments which are part of the related mortgaged file.

(iii) **No Senior Liens.** Except as indicated in the related title insurance policy or opinion of title, the ground lessee’s interest in the ground lease is not subject to any liens or encumbrances superior to, or of equal priority with, the related mortgage, other than the related ground lessor’s related fee interest.

(iv) **Ground Lease Assignable.** The borrower’s interest in the ground lease is assignable to the trustee upon notice to, but without the consent of, the lessor thereunder (or, if any such consent is required, it has been obtained prior to the closing date) or, in the event that it is so assigned, it is further assignable by the trustee and its successors and assigns upon notice to, but without a need to obtain the consent of, such lessor.

(v) **Default.** As of the closing date, the ground lease is in full force and effect and no default has occurred under the ground lease and there is no existing condition which, but for the passage of time or the giving of notice, would result in a default under the terms of the ground lease.

(vi) **Notice.** The ground lease requires the lessor thereunder to give notice of any default by the lessee to the mortgagee; or the ground lease, or an estoppel letter received by

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the mortgagee from the lessor further provides that notice of termination given under the ground lease is not effective against the mortgagee unless a copy of the notice has been delivered to the mortgagee in the manner described in such ground lease.

(vii) **Cure.** The mortgagee is permitted a reasonable opportunity (including, where necessary, sufficient time to gain possession of the interest of the lessee under the ground lease) to cure any default under the ground lease, which is curable after the receipt of notice of any default before the lessor thereunder may terminate the ground lease.

(viii) **Term.** The ground lease has a term which extends not less than 20 years beyond the maturity date of the related mortgage loan.

(ix) **New Lease.** The ground lease requires the lessor to enter into a new lease upon termination of the ground lease for any reason, including rejection of the ground lease in a bankruptcy proceeding.

(x) **Insurance Proceeds.** Under the terms of the ground lease and the related mortgage, taken together, any related insurance proceeds will be applied either to the repair or restoration of all or part of the related mortgaged property, with the mortgagee or a trustee appointed by it having the right to hold and disburse the proceeds as the repair or restoration progresses, or to the payment of the outstanding principal balance of the mortgage loan together with any accrued interest thereon.

(xi) **Subleasing.** Such ground lease does not impose restrictions on subletting.

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2 See footnote 6 in the text of the article.
EXHIBIT 2

With respect to any Mortgage Loan that is secured by an interest of the Mortgagor as lessee under a ground lease (“Ground Lease”) of the related Mortgaged Property, but not by the related fee interest (the “Fee Interest”) in such Mortgaged Property, the Seller hereby represents and warrants to the Purchaser that:

(i) such Ground Lease or a memorandum thereof has been duly recorded; such Ground Lease permits the interest of the lessee thereunder to be encumbered by the related Mortgage and does not restrict the use of the related Mortgaged Property by such lessee, its successors or assigns in a manner that would materially adversely affect the security provided by the related Mortgage; and there has been no material change in the terms of such Ground Lease since its recordation, except by written instruments all of which are included in the related Mortgage File;

(ii) the lessor under such Ground Lease has agreed in such Ground Lease (or in another writing included in the related Mortgage File) that such Ground Lease may not be amended, modified, cancelled or terminated without the prior written consent of the Mortgagee and that any such action without such consent is not binding on the Mortgagee, its successors or assigns;

(iii) such Ground Lease has an original term (or an original term plus one or more optional renewal terms that under all circumstances may be exercised, and will be enforceable, by the mortgagee) that extends not less than 10 years beyond the full amortization period of the related Mortgage Loan;

(iv) such Ground Lease is not subject to any liens or encumbrances superior to, or of equal priority with, the Mortgage other than Permitted Encumbrances; and such Ground Lease is, and provides that it shall remain, prior to any mortgage or other lien upon the related Fee Interest;

(v) such Ground Lease does not permit any increase in the amount of rent payable by the lessee thereunder during the term of the Mortgage Loan [rent increases should be scheduled, and underwriting based on such increases should be demonstrated];

(vi) such Ground Lease is assignable to the Purchaser and its assigns without the consent of the lessor thereunder;

(vii) as of the date of execution and delivery hereof, such Ground Lease is in full force and effect and no default has occurred under such Ground Lease nor is there any

existing condition which, but for the passage of time or the giving of notice, would result in a default under the terms of such Ground Lease;

(viii) such Ground Lease (or other written agreement signed by lessor) requires the lessor to give notice of any default by the lessee to the Mortgagee; and such Ground Lease (or other written agreement) further provides that no notice given thereunder is effective against the Mortgagee unless a copy has been given to the Mortgagee;

(ix) a Mortgagee is permitted a reasonable opportunity (including, where necessary, sufficient time to gain possession of the interest of the lessee under such Ground Lease through legal proceedings or to take other action so long as the Mortgagee is proceeding diligently) to cure any default under such Ground Lease that is curable after the receipt of notice of any such default before the lessor thereunder may terminate such Ground Lease; and all rights of the Mortgagor under such Ground Lease and the related Mortgage (insofar as it relates to the Ground Lease) may be exercised by or on behalf of the Mortgagee;

(x) such Ground Lease does not impose any restrictions on subletting which would be viewed as commercially unreasonable by an institutional investor; and the lessor thereunder is not permitted to disturb the possession, interest or quiet enjoyment of any subtenant of the lessee in the relevant portion of the Mortgaged Property subject to such Ground Lease for any reason, or in any manner, which would materially adversely affect the security provided by the related Mortgage;

(xi) under the terms of such Ground Lease and the related Mortgage, taken together, any related insurance proceeds and condemnation award that is awarded with respect to the leasehold interest will be applied either (A) to the repair or restoration of all or part of the related Mortgaged Property, with the mortgagee or a trustee appointed by it having the right to hold and disburse such proceeds as repair or restoration progresses, or (B) to the payment of the outstanding principal balance of the Mortgage Loan, together with any accrued interest thereon.

(xii) Section Removed
EXHIBIT 3

(i) Each ground lease has been duly recorded and the ground lease permits the interest of the lessee to be encumbered by the related mortgage. No material change in the terms of the ground lease since its recordation except by written instruments all of which are included in the mortgage loan file.

(ii) Each ground lease does not restrict the use of the related mortgaged property by the lessee or its successor or assigns.

(iii) Each ground lease may not be amended, modified, canceled or terminated without the prior written consent of the lender.

(iv) Each ground lease has an original term (or optional renewal terms which under all circumstances may be exercised by the lender) that extends not less than 10 years beyond the amortization of the related mortgage loan.

(v) Each ground lease is not subject to any liens or encumbrances superior to, or of equal priority with, the mortgage.

(vi) All necessary contents have been obtained from the lessor for the assignment of the ground lessor to the lender and its successors or assignees without the consent of the lessor.

(vii) Each ground lease is in full force and effect, there is no existing default under the terms of the ground lease and the Seller of the mortgage loan has not received notice of any default under the terms of the ground lease.

(viii) Each ground lease requires the lessor to give notice of a default by the lessee to the lender and provides for a right to cure.

(ix) Each ground lease does not impose any restrictions on subletting that would be viewed as commercially unreasonable by an institutional investor.

(x) Each ground lease requires that any insurance proceeds or condemnation award will be applied either to the repair or restoration of all or part of the related mortgaged property, with the lender having the right to hold and disburse such proceeds, or to the payment of principal, together with accrued interest, on the related mortgage loan.

(xii) The ground lease requires lessor to enter into a new lease with the lender upon the termination of the ground lease or rejection of the ground lease in a bankruptcy proceeding.

1 Fitch’s General Representations and Warranties for CMBS Transactions.
(xii) Under the terms of the ground lease and the mortgage, any related insurance proceeds, or condemnation award in respect of a total or substantially total loss will be applied first to the outstanding balance of the mortgage loan.