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PERSPECTIVE

The new guide to ground lease drafting and negotiation

Real estate development on ground-leased property has been growing, with municipalities, private parties, and institutional entities using it as a tool for development. Joshua Stein has compiled a comprehensive three-volume treatise to guide lawyers and real estate professionals through the process of drafting and negotiating ground lease transactions.

By Ira J. Waldman

Real estate development on ground-leased property has been growing at an explosive rate. Municipalities with excess land, or even land to be contemplated to be developed, utilize ground leases as a means to control and profit from development. Private parties who do not want to sell land in order to keep property “in the family” for long-term investment have found ground leasing to be an effective tool. And, more recently, several institutional entities have offered ground lease structures as an important element in the capital stack for real estate development.

Over many years Joshua Stein has written articles in several publications dealing with issues that arise in ground lease drafting and negotiation, from the perspective of the landowner, lessee, and the lenders to each of them. Without the ability to secure financing by a ground lessee, as Joshua states in his introduction, “the greatest ground Lease in the world won’t be acceptable as collateral unless its terms take into account the Mortgagee’s interests.”

Rather than requiring practitioners to search for and through the many publications that Joshua has authored over the years, he decided to prepare a compre-



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hensive treatise, incorporating all that he had previously published, as well as much new material, to guide lawyers and real estate professionals through the process of drafting and negotiating ground lease transactions. The result is a three-volume tome “The New Guide to Ground Leases” recently published by ACRE Press and available at www.groundleasebook.com.

Each volume runs approximately 600 pages, with Volume 1 examining the many issues confronting lawyers in the preparation and

negotiation of ground leases in a comprehensible, easy-to-read and understandable manner. Volume 2 includes a Model Ground Lease form in two parts - a “base case” and a “bells and whistles” case, with the latter including just about everything that could possibly arise in a ground lease transaction based on the complexity of the transaction and the points of view of each of the relevant parties. Volume 3 goes beyond the basic Ground Lease form to include document forms and detailed provisions ancillary

to the negotiation and closing of a ground lease transaction, including, for example, an Agreement to Lease, a Completion Guaranty, and, most importantly, Model Leasehold Mortgage language.

The New Guide to Ground Leases is not intended as an academic treatise on case law; however, to the extent relevant to a particular provision or discussion, case law is sometimes noted, which may be useful as a starting point for further research as appropriate. And sometimes almost an ending

point. For example, a particularly complex issue that arises in many ground lease negotiations involves rent resets. In a long-term ground lease landowners have learned, sometimes the hard way, that rent fixed at the commencement of a ground lease will not keep up with inflation, property value, or both, and will attempt to craft an appropriate rent adjustment provision. In Section 70 of Volume 1, Joshua goes into detail surrounding the issues and positions of the landowner and lessee in the negotiation of rental resets and the various mechanisms for such resets. Included in the discussion is the point of view of a leasehold mortgagee considering the impact of the rent reset provision in its underwriting. If the provision is too complex, or may significantly increase the economic burden on the lessee in presently uncertain ways, many potential leasehold lenders will simply pass on the transaction, impacting the ability of the lessee to develop the site. And the more complex the provision, the greater the likelihood of disagreement and potential future litigation that may arise.

And arise it does. So, in addition to a comprehensive discussion of issues surrounding future rent adjustments, Joshua follows up with Section 71 entitled “Rent Resets - Some Major Court Decisions”, which highlights litigation involving the valuation process and interpretation of the language of a rent reset provision when the parties do not provide clear and simple directions for the establishment of the reset rent as provided by Joshua in Section 70. Section 71 provides cautionary tales about what went wrong, what led to expensive and lengthy litigation - and lessons learned.

Many ground leases provide for an element of profit sharing between the landowner and lessee in order to, as Joshua describes it, “find a logically superior and perhaps less risky way to handle Base Rent adjustments.” Joshua reviews the various alternatives and permutations involved in considering a profit-sharing provision, including percentage of gross revenue (with some negotiated deductions), percentage of net revenue (with all of the complexity in defining “net revenue” can entail

and “transaction payments” to the land owner when the lessee refinances or sells the leasehold and improvements (again, with all of the complexity in defining the “profit” that may be shared with the land owner).

Leasehold mortgage loan issues are discussed when relevant throughout the New Guide; however, Joshua also includes almost 80 pages specific to issues to be considered as the landowner and lessee focus on the needs of the leasehold mortgage lender who will be providing the construction financing for the development of the site or the longer-term permanent financing following completion of the project. Of particular interest are the potential rights of the leasehold mortgagee should the lessee default. What notices should the leasehold mortgagee be entitled to? What cure rights should the leasehold mortgagee have? What happens if the lease is terminated? What agreements should be negotiated among the parties to deal with these eventualities to protect the interest of the leasehold mortgagee? These issues scratch the surface of what

is included in the leasehold mortgage sections of the New Guide.

The scope and breadth of the New Guide cannot be minimized, just as they cannot be adequately captured in a review of the New Guide. What can be said is that the New Guide will be an essential tool for practitioners representing landowners, lessees and leasehold mortgagees involved in ground lease transactions and project development. One should not start drafting and negotiating a ground without it.

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