



Use Clauses and Sublet Provisions in Ground Leases



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A ground lease is both a conveyance and a contractual agreement between a landlord (the ground lessor) and a tenant (the ground tenant) pursuant to which the ground lessor, as the fee owner of the real property, conveys a leasehold interest in the property to the ground tenant subject to the terms and conditions of the ground lease. Ground leases are often entered into to facilitate the development of an unimproved parcel of land by the ground tenant and are therefore usually long-term leases (typically at least 50 years, often 99 years) given the time and costs associated with the construction and maintenance of the site improvements; and because at the expiration of the term, title to the land, and usually also the improvements thereon, revert back to the ground lessor. From a lender's standpoint, the remainder of the term of a ground lease should be long enough to amortize the loan and permit refinancing. The minimum rule of thumb is that the expiration of the ground lease should not be less than 20 years after the fully extended maturity date of the loan. The term of the ground lease also has an effect on the marketability of the property after a foreclosure sale. Other reasons why property owners may decide to ground lease their property include restrictions on the ability to sell land owned by certain governmental entities, issues relating to subdividing the property, tax concerns (*i.e.*, transfer taxes and capital gains) and sometimes the owner of the property is simply not interested in developing and operating the building. Ground leases present a host of financeability concerns in addition to the term of the lease, and this article will address two of these issues pertaining to limitations on permitted uses and subletting.

Among other related factors such as zoning, the value of a property that is subject to a ground lease is directly tied to the uses that are permitted under the ground lease. Generally, the permitted use will impact the improvements that may be constructed on the parcel and the income the ground tenant is able to realize from tenants (which are effectively subtenants in the context of a ground lease) and may also be a determining factor in the rent and rent resets under the ground lease

itself. To the extent that the ground lessor has any right of consent over the permitted uses of subtenants, this will likely render the ground lease unfinanceable since such a consent right could severely impact the ability of a property to generate cash flow.

An overly restrictive use clause would limit the ground tenant's ability to market and lease the property to tenants that engage in certain types of businesses. For obvious reasons, limiting the types of tenants to whom the property may be leased will likely have a negative impact on the income that a ground tenant/borrower is able to generate from the property. The permitted use clause should also be broad enough to allow a lender to realize sufficient value from the sale of the borrower's leasehold interest in the event the borrower's intended use proves not to be viable. If the borrower defaults under the loan and there is a foreclosure, it is important that the pool of prospective purchasers is not limited because this may have a negative impact on the purchase price, the proceeds of which the lender will use to pay down the remaining balance of the loan.

Given the lengthy term of ground leases and the relative unpredictability of market forces, the use clause should be broad enough to allow the ground tenant (and, therefore, also the lender or prospective purchaser at a foreclosure sale) to reposition the property if needed due to changes in market conditions. Consequently, a leasehold lender would want the permitted use provision to be as broad and permissible as possible – ideally, “for any lawful purpose.” If the ground lessor insists on certain prohibited uses (*i.e.*, adult entertainment businesses and operations involving hazardous materials), such uses should be expressly set forth in the ground lease. To the extent that a ground lessor does have any type of consent right, if it is not qualified by a requirement of reasonableness, then the ground lessor need not be reasonable and may condition its consent on any number of requests, including the payment of money. Even if qualified by a reasonableness standard, such consent would nevertheless be unacceptable and unfinanceable due to the time delays and administrative hurdles of consent and the “chilling” effect on any tenants not wanting to spend the time on negotiating a lease which is subject to consent rights.

The use clause is closely tied to the right of the ground tenant to sublet. A ground lease should also not impose restrictions on the ground tenant's ability to sublease the property. The ground tenant should be permitted to sublet the property without having to first obtain the consent of the landlord, even if such consent is not to be unreasonably conditioned, withheld or delayed by the ground lessor. Lease provisions that are subject to the ground lessor's consent are problematic for a host of reasons as noted above and often invite prolonged negotiations and litigation based on disagreements on what is considered reasonable, which may result in the ground tenant losing a prospective tenant that needs to take possession of the property and start operating its business. Also as noted above, as a practical matter, it is not uncommon for ground lessors to use the request for consent as an opportunity to require various concessions and additional agreements from the ground tenant that are unrelated to the request for consent and outside the scope of the lease.

Another function of ground leases having long terms is that it is unlikely that the ground lessor that originally entered into the lease is the same person or entity that the ground tenant has a working relationship with when it's time to obtain the

ground lessor's consent, and unreasonable and difficult ground lessors are not uncommon in the marketplace. Further, upon a foreclosure the lender steps into the shoes of the ground tenant/borrower and will therefore be subject to the limitations contained in the ground lease, including any restrictions on subletting. Therefore, flexibility on subletting is critical, and there should be complete freedom for the ground tenant to rent its space.

Another requirement (and needed provision in a ground lease) is the obligation of the ground lessor to provide a prospective subtenant with a subordination, non-disturbance and attornment agreement (an "SNDA") whereby the ground lessor agrees that in the event the ground lease is terminated prior to its stated expiration date, the subtenant's tenancy at the property will not also be extinguished (*i.e.*, so long as the subtenant is not otherwise in default of its sublease the ground lessor will agree to recognize the subtenant as a direct tenant). Such an agreement by the ground lessor will typically be conditioned upon the subtenant agreeing to attorn to the ground lessor if the ground tenant's tenancy under the ground lease is terminated. Most sophisticated tenants will not enter into a lease at a property that is subject to a ground lease unless they have a non-disturbance agreement from the ground lessor. This is also a financeability requirement to ensure that the property is going to continue to have tenants and generate rental income to pay the debt service. To protect ground lessors, many ground leases may condition the provision of an SNDA on minimum leasing parameters or other economic conditions as well.

While there are many financeability concerns when it comes to ground leases, for the reasons noted herein it is critical that the permitted use clause in a ground lease is as permissive as possible and there are no restraints on the ground tenant's ability to sublet the property, along with the requirement for the ground lessor to provide an SNDA.