Chapter 1

The Truth About Ground Leases

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A commercial ground lease is an arrangement by which the tenant/developer leases real property, usually for an extended term, in order to install improvements and operate the property for the production of income. This book is intended as a practical guide to structuring, negotiating and drafting commercial ground leases. Chapter 1 is an overview of ground lease practice and related issues. An overview of the overview is this: ground leases in general, particularly in a development context, are landowners' devices. Ground leases serve landowners well (much better than most joint ventures), but for tenant/developers ground leases are highly problematic. They complicate the development process—sometimes fatally—and usually create a series of issues that, at a minimum, cost time and money even if they do not threaten the project itself.

This book is for those professionals and their clients who are charged with resolving the hundreds of issues needed to create a viable ground lease transaction. This is not a book for the people who are putting together a pool of mortgage loans to sell to investors. It is for the men and women in the trenches who do the hard work of completing a complex deal, which if done right can be the basis of a successful real estate project that realizes the best interests and intentions of all the parties involved.

This book will focus on matters in which ground leases tend to differ, at least in degree, from ordinary occupancy leases.

§ 1:1 Ground Lease Is a Landowner's Device

Ground leases are highly problematic for the prospective tenant, especially when he is a real estate developer. The tenant's issues can be alleviated to a degree by the terms of the lease itself, but cannot be entirely eliminated. The landlord's issues are almost always created by the terms of the lease itself, and should, therefore, be entirely avoidable.

§ 1:1.1 Tenant Financing

Most developers and purchasers of commercial real estate require financing. Any ground lease must be "financeable," or ownership of the leasehold will be limited to a very small group of investors who can purchase for cash. The lease may be viewed as part of the project financing, avoiding the need to finance the (non-depreciable) cost of the land, but nevertheless it complicates financing of the project. The essence of the problem is that the tenant under the ground lease has only a leasehold estate to secure project debt (unless the landowner has imprudently agreed to "subordinate" the fee, that is, mortgage the fee interest to secure the tenant's financing).[1] Continued ownership of the leasehold is subject to termination upon tenant default and in certain other events, and the lease is, in any case, in its nature a wasting asset. Even where the lease is "financeable," both debt and equity financing will be harder to find and more expensive and time consuming.[2]

§ 1:1.2 Control

For the developer, the ground lease is a serious complication, making project execution more difficult. The developer needs the landowner's acquiescence or participation in permitting, financing, insurance, leasing, and sale, and may, under the terms of the lease, require her affirmative approval of design, operations, subleasing, and change of use. If development of a commercial real estate project is a complex game, development of a ground lease project is three dimensional chess.

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1. Chapter 4 of this book addresses ground lease financing in general; chapter 5 addresses "subordination of the fee"; and chapter 6 addresses leasehold mortgages.
2. Construction financing for real estate development is, currently, virtually non-existent, with the exception of apartment projects in some urban areas. There were three CMBS offerings in all of 2009, all in the fourth quarter, for an aggregate of $1.36 billion, and less than $20 billion in all of 2010. Estimates for 2011 are about $40 billion, which is recovering but still minor compared to $240 to $318 billion reported for 2007. Virtually all the new funding will go for the refinancing and acquisition of existing properties. *See* Caton, *Excess Capital Spurs Buyers into Purchases for Fear of Missing Deals*, NAT'L REAL ESTATE INV., Mar. 2, 2011, *available at* http://nreionline.com/finance/news/excess_capital_buyers_deals_0302/; *The State of the Securitization Markets: Hearing Before the Subcomm. on Securities, Insurance and Investment Comm.*, 112th Cong. (May 18, 2011) (testimony of Lisa Pendergast on Behalf of the Commercial Real Estate Finance Council), *available at* www.crefc.org/uploadedFiles/CMSA_Site_Home/Government_Relations/Financial_Reform/Risk_Retention/CREFC_Testimony_Senate_SII_Subcommittee5-18-11.pdf. *See infra* section 6:13.1. Meanwhile, corporate bond financing has returned to near normal levels.

§ 1:1.3 Tenant's Toxic Lease Terms

Often, a ground lease is employed in the first place because the landowner is unwilling to sell the property. The site is usually highly desirable in a favorable market so that the developer is anxious to proceed with the project. In a rush to tie up the land and start development, the tenant can make serious mistakes in the ground lease. The developer may promise the landowner a specific project and a generous rent. The landowner may require periodic rent adjustments over the term as well as some project participation, and may want to restrict transfer by the original tenant whom she has specifically chosen to develop her property. As a result, the lease may create a point where the ground rent is reset by indexing to inflation, or by appraisal to reflect some higher and better use of the land than that represented by the original project, and which reset rent the existing project cannot then afford to pay, while the tenant is restricted by economics or the terms of the lease from adopting any other use. Restrictions on use or sale by the tenant or potentially uneconomic rent adjustments, as well as defects in the financing provisions of the lease, may threaten the initial project financing, both debt and equity, and later refinancing.

§ 1:1.4 Landowner's Toxic Lease Terms

The ground lease is a landowner's device. In most cases, the ground lease results because the owner of a highly desirable parcel does not want to sell her land. She often has an abiding faith in the long-term value of real estate, for herself and her heirs, and may distrust alternative investment vehicles. She is usually seeking a steady and secure income stream that can be relied upon for many years, with adjustments to offset inflation. The ground lease can accomplish these goals and avoid a taxable sale during her lifetime. The primary downside for the landowner arises only by making a bad deal with the tenant.

Two obvious pitfalls for the landowner are first, choosing an unscrupulous and/or incompetent tenant/developer, and second, agreeing to "subordinate" her fee interest in the property. Both should be easy to avoid, with a modicum of good professional advice. But even when the owner does not commit these obvious mistakes, a poorly structured ground lease may leave her with only a small part of the value she expects from the transaction.

The landowner's bad deal is the flip side of the tenant's. The tenant wants to avoid being locked into a lease position where the rental is adjusted periodically—by index or appraisal—in an amount that the existing project cannot afford to pay, and without the ability to redevelop or change the use to be more profitable. The tenant's

solutions to these issues may result in the opposite problems for the landlord. Where the rent is essentially fixed or subject to limited small adjustments over the term of the lease that cannot keep up with inflation, and does not reflect the value of the land as a component in the project; or where the developer controls the use and redevelopment of the property long after the useful economic life of the initial project, without the landowner having any participation in any increases in value over time; then the ground lease becomes a fixed annuity with little if any equity value, and conveys to the tenant virtually all the long-term value of the land.[3]

§ 1:2 Term, Rent, and Use: An Introduction

§ 1:2.1 Generally

The worst deals for both landlord and tenant involve some combination of these three elements: length of the ground lease term, including renewals; base rent with periodic rent adjustments during the term, as extended; and the right to determine the use of the property and improvements. Often one party or the other is in a superior bargaining position due to project economics or the ignorance of the other, and can impose terms to his or her advantage, leaving the other with a potentially bad deal. This doesn't have to be; neither greed nor fear need prevail. The interests of both can be accommodated within a workable framework, without compromising the essential interests of either. Of course, the issues discussed below are not the only ones the parties must resolve in arriving at a final ground lease; many others will be discussed over the course of this book. But these are the critical issues that most often arise and most often prove to be deal-breakers.

§ 1:2.2 Term

The ground lease term should be appropriate to the project the developer is building in terms of its expected economic useful life. This may seem a vague concept, but in practice the expectations of users, developers, and financing sources are fairly well determinable. This is more an economic determination than a question of the physical obsolescence of the improvements. The project must be expected to earn sufficient cash flow to repay the costs of development and pay a "reasonable" return to investors, considering the attendant risks. If renewal options or rent adjustments arise before the end of the expected useful economic life, then these need to be based on the established use of the property. If the tenant wants to maintain

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3. *See infra* section 1:13.

the lease beyond the anticipated economic life, then rent should be subject to reappraisal to reflect the land value at its highest and best use.

§ 1:2.3 Rent

Initial base rent is usually set at an agreed amount (a market rate of return on the value of the property) as a first condition to the ground lease agreement. Subsequent adjustments are usually the issue. During the expected useful life of the project, increases in rent should recognize that the land is committed to the project and should be within a range that the project should be able to pay, reflecting the value of the land as a component of the project. After that initial term is over, if the lease is to continue (presumably at the option of the tenant), then rent should be adjusted to reflect the highest and best use of the property.

§ 1:2.4 Use

The parties usually agree on the initial use of the land, as well as the initial base rent. Subsequent changes in use may require the landlord's consent. A material change in use should occasion a fresh look at the rent. If the lease does not provide for reconsideration of the rent in connection with a proposed change of use, the landlord may be deemed "unreasonable" under state law if she requests a rental adjustment as a condition to approving the change of use. Changes in use may seriously impact a percentage rent provision in the lease. The developer should have latitude to adjust uses to maximize the economic value of the land and the improvements, and in that event it may be that the rent should be adjusted to reflect a more profitable operation.

Given the rate and magnitude of change in the economy, the need to adjust the use may increase proportionately. Technological changes may impose burdens and create opportunities unthought-of when the ground lease was written and long before the anticipated economic useful life of the original project is over. Substantial redevelopment of the improvements and/or new or different uses of the project may require adjustments of the rent, term, and/or use and might be made available under some trigger mechanism built into the lease. A ground lease must survive over many decades, and the best ground leases will have the means of adjusting to accommodate the interests of the parties over the years.

At the end of the useful life of the initial project, the tenant may have the option to continue the lease, to squeeze the last drop of value from the existing improvements or to develop a new project, but in either case the rent should then reflect the value of the land for its highest and best use.

§ 1:3 Why Ground Leases?

§ 1:3.1 Generally

Ground leases are used for all sorts of purposes, including farm land, residential condominiums (especially in Hawaii) and innumerable other purposes, from single-family homes to baseball stadiums to duck blinds. This book, however, focuses on leases of property for commercial real estate development. Typically, the tenant is a developer or related entity that intends to construct new improvements or renovate existing buildings, incur construction and term financing secured by the property, and lease or operate the property for the production of income. A properly structured ground lease will allow the tenant's equity in the project to be financed, sold and otherwise dealt with independently of the fee ownership of the land. Virtually all types of commercial projects are sometimes developed on ground leases: office buildings, hotels, shopping centers, industrial, storage and healthcare facilities, and residential apartments.

Whatever the type of project, in order to assure the feasibility of development and the availability of project financing, there are a number of provisions in the ground lease that need to be negotiated successfully. These are discussed in sections 1:4, 1:5, and 1:6 below, but first it may be useful to consider why ground leases are sometimes used for commercial real estate projects.

In most circumstances, a ground lease is used because the landowner refuses to sell her land. Occasionally a situation will arise where the owner of real property *cannot* sell ground that the developer is interested in developing, due to a lack of legal authority to sell (for example, a port district or private trust). Much more often the groundowner is simply unwilling to sell. Some institutions, and sometimes private individuals, as a matter of policy, want to maximize fee ownership of real property. Owners with these objectives may be willing to consider only lease proposals.

Frequently, an owner of property is unwilling to sell because her tax basis in the property is nominal, so that a sale would generate a substantial taxable gain. The Internal Revenue Code, including the estate tax provisions, may encourage holding commercial real estate until death in order to obtain a basis step-up.[4] Sometimes a tax-free exchange under Internal Revenue Code section 1031 can be used to solve this problem.

From the groundowner's standpoint, the long-term ground lease has the advantage of not being a taxable sale. It was once relatively

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4. *See* Cassanos, *Alternatives to Disposition of Real Estate: Participating Loans, Convertible Loans, Net Lease and Joint Venture Arrangements*, 48 INST. ON FED. TAX'N 31.1–.41 (1990).

common to see ground leases that contained an option to purchase granted to the tenant, which option was exercisable on the death of the groundowner. That sort of option may still serve some purposes, but does not by itself provide answers to fundamental issues that must be resolved in order for the tenant to obtain project financing.[5]

Often the owner of real estate simply wishes to maintain ownership of particular property because she believes it is the best available investment. The alternative in the event of a sale is to take the proceeds after paying substantial sales costs (commissions and other expenses to the seller are often 5% to 10% of the sale price) and applicable taxes, and purchase some other investment: stocks, municipal bonds, bank deposits, oil and gas leases, or other real estate. Many landowners find it difficult to establish a "reasonable" price for their property due in part to market uncertainties (for example, inflation and interest rates) and in part to uncertainties created by changes in governmental policies, including local land use codes and federal income tax legislation.

Theoretically, the market should establish a price for land or any other commodity; however, all markets are at best imperfect, and land is an illiquid and unique asset. Landowners sometimes conclude that they cannot determine with confidence what the "fair market" price should be except at levels so high that the developer, on the other side of the same uncertain equation, cannot justify the expense.

The ground lease may present advantages to the groundowner who is disinclined or uncertain about selling. For the right project with the right developer, a well-structured ground lease can provide to the landowner

(1) a minimum reasonable return reflecting the current value of the property;

(2) a participation in the project that should keep the return reasonable in relationship to market value over time; and

(3) further value in the long-term ownership of land, which will revert to the landowner on expiration of the lease, together with the improvements built on the property.

A ground lease has served many landowners as a low-risk means of developing their property, providing for professional development and management, and resulting in a secure income stream that the owner may use as collateral for her own financing.[6] Nevertheless, the landowner does undertake some degree of risk in a long-term ground lease

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5. *See infra* section 4:8.
6. *See, e.g.*, Neil S. Hecht, *Variable Rental Provisions in Long Term Ground Leases*, 72 COLUM. L. REV. 625, 629 (Apr. 1972).

with a developer/tenant. Of course, the risks escalate seriously if the landlord agrees to "subordinate" the fee.[7] But even if the land is not subordinated, the landowner, with respect to any lease proposal, should conduct an independent analysis of the proposed project to determine if it is viable and whether it represents an appropriate use of the site.[8]

From the developer's viewpoint, a ground lease might be attractive in a purely economic sense as a relatively inexpensive means of financing acquisition of the land, especially when the market (or the landowner) values the land in excess of what the developer's project can comfortably afford to pay. If the landowner agrees to "subordinate" her land to the tenant's financing, a ground lease will increase the developer's leverage in the project and reduce any equity requirement. Nevertheless, most developers conclude that the problems of dealing with a ground lease outweigh the advantages in a complex commercial development. From the developer's standpoint, a ground lease complicates almost every element of a project. Ground leases are usually written in periods of peak development activity, when land is in high demand among competing developers, and the prospective tenant cannot afford to be too choosy.

In addition, the expense associated with a ground lease, including legal and other consultant's fees and financing costs, are substantially greater, not only in the preparation of the original lease, but for many of the ensuing steps in the life of the project. For the developer, buying the land is almost always cheaper in terms of transaction costs.[9]

Ground leases are a landowner's device.

§ 1:3.2 Corporate Strategy

The ground lease is a landowner's device. One example arises in the case of some large corporations that acquire sites intended for new corporate headquarters, when the efficiency experts have convinced management that consolidating dispersed operations will improve productivity. The corporation hopes to house its existing staff in an integrated facility and to provide for anticipated growth when the need arises, often within a time horizon of ten to twenty years. If the desired new site is in the suburbs or the rolling green hills of Tennessee or some other exurban sanctuary, it is easy enough to build a series of

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7. *See infra* chapter 5.
8. *See* Wetmore, *Lessor Beware! A Land Lease Is Usually a Partnership*, URBAN LAND 20–23 (Oct. 1998).
9. *See* Leonard, *Summary Remedy Provisions Create Unreasonable Risks in Long-Term Leases*, 17 PRAC. REAL EST. LAW. 41, 45 (Jan. 2001).

buildings on the campus to house the initial population and the later arrivals. Holding part of the property for later development is usually a prudent economic decision.

If, however, the site is in a highly developed urban core, requiring high rise construction, then the project may dictate initial development of space for the immediate requirements plus all the additional space to provide for anticipated future growth. The space built that is not required at first will need to be leased to others until it is absorbed, in order to cover, or at least mitigate, development and carrying costs. That will require leasing and management of the "spec" space. Many companies who are not in the real estate business conclude that the risks of high rise development, leasing, and management can best be managed by professional developers, and that, while a developer can be hired on a fee basis, providing the third party developer with a profit incentive tied to the spec space will allow the corporation to pass much of the development, financing, construction, and leasing risks to the developer. A contract developer will leave most of this risk with the corporate owner; prudent fee developers will be unwilling to risk anything more than the fee on the project outcome (though the contract can be structured with incentives, that is, bonuses, for timely completion, cost controls, etc.). With a contract developer the corporation will remain generally liable with respect to the development, although with some indemnity, perhaps, from the developer, at least with respect to costs giving rise to lien claims against the land.

A ground lease is a useful device in this context. The transaction might look something like this:

The corporation ground leases the site to the developer, by which the developer undertakes to develop the building in accordance with plans approved by the corporation. Simultaneously, the parties enter a space lease by which the corporation agrees to "sublease" from the developer a substantial portion of the building for its headquarters upon completion of construction, with options to lease expansion space over the term of the lease, usually amounting to most if not all of the remaining space in the building. The tenant will own the improvements until the expiration of the ground lease term, but the corporation will have the option to buy out the tenant when most of the option space has been taken up by the corporation (which may be a mutual put-call option). The tenant will have tax benefits to help attract equity investors and the space lease as the primary credit for project lenders (the corporation will need to enter attornment agreements with mortgagees). The corporation should have no direct liability with respect to the project; if the fee interest in the property is subject to lien claims under local law, there are a number of ways to manage the risk (see *infra* section 10:4).

The space lease rental rate may be based on actual costs and financing rates (with some maximum), and represents a no profit position to the developer (other than development and building management fees), or may be negotiated in advance based on market conditions, or some combination of these.[9.1] The expansion space options need to be crafted to allow the corporation to meet its space needs while still allowing the tenant/developer the ability to lease the spec space to third parties in the interim at something like market lease rates (for example, a schedule of full floor take downs at two year intervals after the first five years; rights of first offer on space coming up at other times, etc.; various trade-offs need to be negotiated). The lease rate for the corporation for the additional space will usually be the original space rate with adjustment for increases in operating costs. The buy out price to the ground lease tenant may be based on a purely mathematical formula, using then rental rates for the remaining spec space, with a discounted present value.[9.2]

The corporation may maximize project economics with a request for proposals (RFP) to prequalified developers. The corporation will need its own advisors to address technical building requirements and the deal structure. The principal architect, usually chosen by the corporation in advance, will need to be acceptable to everyone. The general contractor will usually be part of the developer's team. A reasonably detailed RFP will help developers respond meaningfully to the corporation's concerns, but should allow flexibility for responders to make suggestions of their own without penalty. Developers should be wary of RFPs that seem overly vague; it is not uncommon for corporate insiders and/or technical advisors to create a "black box" where only one competitor knows the "correct" answer.

Government agencies with similar requirements may consider this approach to meeting their space needs, but legal requirements can create additional issues. An agency may lack statutory authority to sell or lease the building site, or the law may require fair market value appraisals for the land sale or lease, and for the buy out as well, that may be inconsistent with the economics of the transaction. It is much more common for governmental entities to employ contract developers,

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9.1. Determination and treatment of the costs of the inevitable changes that the corporation will request during the development and construction of the project can be contentious. Even "interior design" changes can affect building systems in unanticipated ways.

9.2. If the initial space rate to the corporation is based on cost of development and the long-term financing rate, it is possible, depending on rental market conditions, that the corporation's rate can exceed the market rate for comparable space. Then the purchase price may be zero, but may relieve the tenant/developer from a losing position in a bad market (one reason the tenant/developer may want a put option at some point).

which seem to provide greater control (and financial risk) and may be less subject to public criticism, especially if the developer ends up making a lot of money on the deal.

§ 1:3.3 The Joint Venture Alternative

Frequently the parties will recognize that, as an alternative to the developer's buying or leasing the land from the groundowner, they might become partners with respect to the project. The landowner would contribute the land and the developer would do all the other things necessary for development of the project.[10] The contribution of the land to the joint venture is generally tax-free. Thus the groundowner has achieved many of her tax and business purposes while permitting the developer to proceed with the project.

Returns to the landowner as a partner in the partnership can be structured so that they are substantially equivalent to the return to a landlord under a ground lease (and vice versa). The partnership may provide a minimum, priority return to the groundowner with the characteristics of minimum rent under a lease. The landowner as partner may obtain a participation in cash flow of the partnership beyond the minimum return, which participation may be the substantial equivalent of percentage rent or other periodic rent increases. From a purely economic standpoint, the joint venture terms can be structured to mirror a ground lease.

However, the nature of the joint venture is such that the groundowner as partner will tend to obtain potentially greater economic interests in the project than she might as landlord under a ground lease. Correspondingly, the groundowner (or her interest in the land) will also tend to be exposed to a greater level of risk as a partner, particularly in the development phase of the project. The skewing of the economic and tax aspects, and the landowner's attempt to control and minimize development-related risks, creates for the developer the principal disadvantages to the joint venture.[11]

§ 1:3.4 Tax Aspects

From a tax standpoint, a joint venture (or limited liability company) may be more advantageous to the groundowner than the landlord's position under a ground lease. (A limited liability company is generally treated as a partnership for federal income tax purposes.) The joint venture gives to the groundowner a share of depreciation, amortization, investment, and rehabilitation tax credits, and similar items

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10. *See* Cassanos, *supra* note 4, at 31.36–.41.
11. *See generally* Freedman, *Structuring a Landowner/Developer Joint Venture Agreement*, REAL EST. REV. 55–60 (Summer 1996).

that may be available under the Internal Revenue Code, so that a substantial portion of the return to the groundowner as partner may be tax-free (even though there may be restrictions on using tax losses against income from other sources). The ground rent, of course, will all be ordinary income (but might be offset by passive real estate losses).

The Internal Revenue Code is one area where the ground lease is to the developer's advantage: his investment in the project is going into either depreciable improvements or deductible ground rent, and there is not a large amount of project cost allocable to the purchase price of nondepreciable land. However, bringing the landowner in as a partner in the project may result in the allocation to the landowner of tax deductions and losses that the developer may want for his own use or to attract equity investors to the project.

However, as a general proposition, tax considerations are not usually determinative here. Groundowners who are not willing to sell the land would usually rather lease the ground than enter into a venture relationship with the developer, notwithstanding possible tax benefits. It is more often the developer who prefers the joint venture to the ground lease, even though the lease may be more attractive to him from a tax standpoint.

§ 1:3.5 Risk and Control

From the developer's perspective, it is best to own the land. If the land is not for sale, or the price is too high, then it is better to joint venture the project; even when a ground lease may avoid the high cost of the land purchase and be better from a tax standpoint, the additional problems of separating the developer from the fee title will usually weigh against the lease.

However, the landowner as a partner may decide that the risks associated with the development process are unacceptable. The alternative of giving up the tax and equity advantages to allow the developer to take these risks is frequently very attractive; these are the sort of problems the developer is in business to manage. Usually, it is the hope of obtaining a secure income stream without the risks associated with development or operation of commercial property that is the landlord's primary goal upon entering a ground lease.

The major joint venture issues usually include:

Landlord Approvals. The groundowner as partner usually wants a say with respect to the development of the project and use of the land, including planning, financing, design and execution of the project, and property management after completion. She may want at least a veto over major design decisions, a say in admitting cash equity partners to the venture (with possible dilution to her interest in the venture), and

approval of mortgage financing and major lease commitments. The landowner will be relatively unknowledgeable and may have objectives at variance with those of the developer; for instance, she may object to design changes that the developer must make because of cost considerations. The need to obtain approvals will further complicate negotiations with lenders and occupancy tenants. Developers find this sort of review and approval at best burdensome and frequently a real problem in the development process.

Many of the same approval issues arise in the context of a ground lease, especially when the landlord is asked to subordinate the land to the tenant's mortgage financing.[12] Even so, the more limited nature of the landlord's interest in the project and exposure to project risks often allow a more limited scope to the landlord's approval rights in the lease than in a joint venture. From a legal standpoint, the relationship of landlord and tenant necessarily involves some degree of opposition between their interests; but in a partnership, the managing partner (presumably the developer) will owe a fiduciary duty to protect the interests of his landowner partner. The developer as tenant under the ground lease usually has greater latitude to pursue his own ends in the development, operation, and disposition of the project.[13]

Ownership and Sale. In agreeing to a joint venture, the landowner implicitly agrees that the fee interest in the land will be owned by the venture and be subject to financing for the project; and that, in the event of dissolution of the venture, the project and the land may be sold. In effect, the land will be subject to the tenant's project financing. If the landowner was unwilling to sell the land in the first place, she may be unwilling to accommodate the developer's need to sell the project. The burden will be on the landowner, in this case, to negotiate alternative resolution of these issues.

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12. *See infra* section 5:5.
13. There may be, between landlord and tenant, an "implied covenant of good faith and fair dealing," that is, an implied agreement not to do anything to undermine the other party's benefits under the lease. Unlike the fiduciary duty of one partner to another, this normally would not require affirmative acts by the landlord or tenant that are not otherwise that party's contractual obligation under the lease. Downtown Barre Dev. v. C&S Wholesale Grocers, Inc., 857 A.2d 263, 270 (Vt. 2004). But it is at least possible that an act permitted under a lease (for example, a change in use) might be deemed taken in "bad faith," and that determination might be a question for a jury. Olympus Hills v. Smith's Foods, 889 P.2d 445, 451 (Utah Ct. App. 1994). *See* Daniel B. Bogart, *Good Faith and Fair Dealing in Commercial Leasing: The Right Doctrine in the Wrong Transaction*, 41 J. MARSHALL L. REV. 275 (Winter 2008) [hereinafter Bogart], for the argument that an implied covenant of good faith in a commercial lease creates uncertainty regarding the effective terms of the agreement, "lessens the value of careful lawyering and protects sophisticated parties" from the consequences of their decisions. *Id.* at 278.

Investors in real estate frequently have time horizons between three and fifteen years for ownership and sale. Developers may be primarily interested in short-term "development" profit arising from implementing a project through initial stabilized occupancy, to be realized by sale at a price in excess (hopefully) of development costs. Other investors may be interested in longer-term appreciation from changes in market rents. Real estate investment strategies change, depending on markets, sources of financing, tax laws and many other variables. But, in any event, developers and equity investors will always require the ultimate ability to liquidate their investments in order to realize the values they hope to create. The developer and the landowner may be unable to agree when, if ever, their partnership should sell the property.

To some extent, these concerns may be addressed in the buy-sell provisions of the joint venture agreement. For instance, in the event the developer and the investor partners want to sell the project, the landowner partner might have the right to buy them out at a price reflecting the value of the real estate (that is, the amount the developer/investor would have received if the project were sold for fair market value and the venture liquidated). As a practical matter, the landowner (who is not a financial institution) is usually not in a position to raise this kind of money on relatively short notice, and project financing might prohibit a change in ownership that puts the landowning partner in charge. (There may also be important tax effects to a change in majority ownership of the entity.) If the landowner is itself an institution, these problems can usually be resolved.

One principal advantage of a ground lease is that it creates two separate estates in the land, the landlord's fee interest and the tenant's leasehold estate, each of which can be held, mortgaged, sold, devised, and assigned separately from the other and without disturbing the estate of the other.[13.1]

Relative Contributions. Frequently, in the joint venture context, the groundowner perceives that her land is put at risk in the development of the project while the developer appears to have little or nothing to lose if the project is a failure and may even walk away with development fees in his pocket. Of course, if the project fails for any reason, the mortgage will likely be foreclosed and the land will be lost. At a minimum, the landowner partner will want to see substantial equity contributed by the developer or his investors, and more troubling, may want some assurance that the land will not be lost or that she will be compensated if it is.

Most real estate developers are relatively short on cash and are in the business of "creating" value by producing projects that are worth

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13.1. *See infra* section 4:7, at note 9.

more than they cost. Developers avoid committing their available cash to long-term investment in development projects. Landowners are by nature substantially more conservative creatures who will view the "created value" as considerably less certain, especially when compared to the value of their land. Rather, the landowner often thinks of herself as having contributed valuable land when the developer has not only avoided making any "real" contribution but is extracting fees from the budget. These kinds of conflicts tend to undermine joint venture negotiations.

Allocation of Risks. In most commercial real estate developments, there are two significant areas of risk: the costs of construction and development; and the marketing (usually leasing) of the completed property. Construction and development cost risks are a developer problem that in the normal course can be managed by means of maximum price construction contracts, interest rate hedges and the like, but can never be entirely eliminated (for example, strikes). Marketing risks (for example, leasing of a multitenant project or the sale of units in a new condominium project) are generally unavoidable unless the project is essentially pre-leased to credit tenants or pre-sold to users. Even then, a severe economic downturn may reduce "credit" tenants to bankrupts; and "buyers" famously disappear when the units they had agreed to purchase turn out to be less valuable than they had imagined. These are the risks that the developer is in business to take; the landowner is not, and will see the risks as greater than the developer does. The landowner as partner will in general share these risks with the developer (though the risks may be mitigated by various guarantees from the developer). The landowner as landlord under a ground lease will not share these risks except to the extent her land is subordinated to project financing (which may be mitigated by imposing conditions to the subordination).

Many professional developers have backed away from joint ventures because of the difficulty of reaching an agreement in the first place with landowners and because developers have found that landowner partners tend to create continuing problems in the development process, especially when projects have problems. An unsophisticated and frightened landowner as a joint venture partner can create substantial additional headaches for the developer when he is already struggling to resolve the host of problems presented by a troubled project. Still, from the developer's standpoint, the joint venture may be preferable to a ground lease.

Perhaps the worst position for the developer is where the landlord on the ground lease is also a partner in the ownership entity. This occurs usually in order to give the landowner additional incentives in terms of tax benefits and project participation, while limiting the costs for purposes of project financing. In this event, the tenant/developer

ends up with most of the disadvantages of both a ground lease and a joint venture.

§ 1:4 Major Issues: Rent, Terms, and Use (Redux)

§ 1:4.1 Rent

Agreement about the ground lease rental provisions is, of course, critical to the deal. The initial minimum rent usually represents an agreed-upon rate of return on the value of the land at the time the lease is signed. The rate may be affected by other terms of the ground lease, particularly the extent to which the landowner's interests are subordinated to the tenant's financing. The difficult issues, after first settling the initial base (or minimum) rent, are usually adjustments to the base rent over the term of the lease and any renewals, and the determination of additional or percentage rent, if any.

§ 1:4.2 Term

The typical ground lease term will be anything from twenty to 100 years. In general, the initial term, prior to renewals, should reflect the expected useful economic life of the project to be developed. However, that is often not the case, sometimes for good reasons, but too often because the parties did not think about it, or because ninety-nine years seemed like the right thing to do, or because one party was in a position to take advantage of the other. An initial term with several options to renew may give either the landlord or the tenant an important advantage, depending upon the rent and other terms of the renewal.

In any event, the term is almost always, at least potentially, many years in length, and the parties and their counsel have the task of drafting an instrument with which future generations will have to live and that must anticipate changing circumstances that can be at best dimly perceived today.

§ 1:4.3 Use

Most leases, including many ground leases, provide that the property will be used only for the purposes contemplated at the time the lease is signed, and that no material alterations or changes to the improvements or the uses will be made without the landlord's consent. But changes in technologies or the vagaries of the marketplace can turn a once-profitable project into a dinosaur, sometimes long before the end of the expected useful life of the improvements. Many project lenders will balk at use restrictions unless the nature of the project is clearly tied to one use, for example, a high-rise office building—although even some of these structures have been known to

turn into hotels. The tenant may be obligated to pay rent that the project is no longer able to produce, with limited ability to adapt the property to more profitable uses. If the tenant can unilaterally change the use and/or the improvements, damage may result to the landlord's interests in the project, in percentage rents arising under the lease or in adjoining properties, or by adopting a more profitable use without any additional compensation to the landlord for the value of the land.

§ 1:4.4 Adjustments to Basic Rent

The landowner's concern is that over the length of a long-term lease the initially fair base rent will be rendered unreasonably low by inflation. The developer's concern is the adverse effects of rental adjustments on the economics of the project, especially project financing.

The simplest notion (and common first proposal) is periodic cost of living adjustments. Most leasehold lenders will hesitate to underwrite a loan secured by a ground lease with potentially unlimited cost of living adjustments; future, compounded COLAs are unknowns. The potential value of the project is difficult to assess if the future ground rent is not determinable. Indexes of inflation (for example, the CPI) typically do not move directly with the market value of real estate, although over extended periods (for example, twenty years or more) differences will usually even out.

Another common approach to base rent adjustment is periodic reappraisal of fair market rent. The developer's problem is that when land values change, an older building may not be able to pay ground rent if the land's then value is based on its "highest and best use," that is, some different use or some larger (or technologically more efficient) project. Again, the future ground rent expense becomes too uncertain for many lenders and equity investors.

There are compromises that will mitigate these problems. Indexed increases in base rent may be set at a percentage of the actual increases in the index (for example, 50% of CPI). Reappraisals occurring before the end of the project's expected useful economic life may be based on the existing use of the land, taking into account the size, age, use, and other relevant characteristics of the improvements at the time of the determination; increases by index or appraisal may be capped. Often the parties agree on a schedule of base rent increases during the earlier years of the lease term; these provisions may be more practical in leases with relatively short terms, involving small projects. Rent increases might also be waived in favor of a leasehold lender after foreclosure. A properly structured percentage rent provision is another means of setting ground rent to achieve fair returns to the landowner based on the profitability of the project, while

protecting the developer's ability to finance, operate and refinance the project.

§ 1:4.5 Percentage Rent

Percentage rent may be based on gross receipts, or net income, but more often on some measure of the project's cash flow (or earnings before interest, taxes, depreciation, and amortization: EBITDA). Additional rent would be an agreed percentage (which, again, may reflect other terms of the ground lease, especially whether the fee is subordinated) of EBITDA in excess of a set amount. The set amount should be something like the initial pro forma stabilized EBITDA used in the original project financing (perhaps as established by the mortgage lender's appraisal). This gives the landowner a percentage of the project's growth in value over time after initial development but protects the project cash flow required to pay the initial term mortgage and equity returns. Percentage rent may affect later refinancings of the project, but usually only at higher debt levels.

The main problem with percentage rent is usually the complexity that it introduces to a ground lease that is already complex enough, and the potential for future disagreements in the determination of the rent. Defining EBITDA (or "net cash flow," "net income," or whatever measure of profitability the parties may agree upon) raises a host of issues for lawyers and accountants. Simple measures of gross receipts may be inappropriate for rent determination (and a percentage of gross receipts without deductions for any operating costs or taxes may impact financeability), and real estate accounting is famously at odds with generally accepted accounting principals.[14] Often, both the landlord and tenant want to avoid percentage rents. However, for a major ground lease project among sophisticated parties, percentage rent can be a basis of an acceptable long-term relationship.[15]

§ 1:4.6 Renewal Rent

Once options to renew the term accrue and the tenant is no longer committed to the lease, the landlord has a much better case that base rent should be adjusted to reflect the then value of the land based on its then highest and best use. The initial term of the lease should reflect the likely economic life of the project. Subsequent renewals without major redevelopment may represent the tenant's attempt to squeeze the last little value out of the old improvements.

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14. *See, e.g.*, Appendix A, *infra*, section 2 of the ground lease.
15. *See infra* chapter 3.

§ 1:5 Major Issues: Financing

The major financing issue between the landlord and tenant is usually whether the landowner's fee will be subject to the developer's mortgage. Most landowners do not and should not agree to put their land at risk, but sometimes, without a fee mortgage, the developer will not be able to finance the project.

Twenty years ago, smaller commercial projects were often financed by savings and loan associations. When the security was a leasehold interest, the frequently unsophisticated lender may have ignored many subtleties of the transaction. Today, savings and loans have virtually disappeared and smaller projects may be funded by commercial banks using standard form loan documents. The additional analysis and diligence required to structure a leasehold mortgage is often inconsistent with the lender's and the project's economics. In a development context (as opposed to an existing project with established occupancy), it may not be feasible to finance small commercial projects with only a leasehold estate.[16]

Conversely, larger projects that can pay the freight may be more easily financed using leasehold mortgages than was true thirty years ago. The statutes governing leasehold financing, especially the federal Bankruptcy Code, have been clarified to eliminate ambiguities that some financial institutions saw as impediments to leasehold financing. The American Bar Association has published Model Leasehold Encumbrance Provisions that provide landowners, developers, and lenders throughout the country with a basis for arriving at ground lease provisions that will be acceptable in most circumstances for mortgage financing.[17] Therefore, the requirements of a "financeable" ground lease are no longer the secrets of a small coterie of New York lenders' and developers' lawyers.[18]

§ 1:5.1 Subordination Agreements

Sometimes the landowner will agree to "subordinate" her fee interest to the tenant/developer's financing, usually at some substantial cost to the tenant in terms of the base and/or percentage rent.

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16. An exception has been developers of smaller retail projects with established banking arrangements and standard forms of ground leases; those form leases are often problematic for landowners. *See infra* section 1:12. More recently, many of these established financing sources have disappeared or have been forced to withdraw from the market, at least temporarily. Many of these lenders, with too many development loans on their books, have ceased to exist.
17. *See infra* section 6:7.
18. Of course, in 2011 financing any commercial real estate development project may not be feasible, other than apartments.

"Subordinate the fee" is technically a misnomer but is generally understood to mean that the landowner subjects her fee interest to the tenant's mortgage, so that, if the mortgage is foreclosed, the lender acquires the land free of the ground lease and the obligation to pay rent. Generally, the landowner, absent some compelling special circumstances, should not subordinate the fee.

The developer, negotiating a ground lease long before financing is arranged, will want the greatest possible flexibility regarding future financing terms. The landowner, if she agrees to subordinate, should want some constraints, at least, as to loan amount, interest rate, balloon payments, and the like. Abuses perpetrated in the name of subordination agreements have led to a substantial body of law attempting to protect unsophisticated landowners from sometimes rapacious developers. A leading case refused to enforce a subordination agreement because it did not "contain terms that will define and minimize the risk" to the landowner. The irony for the developer is that the provision of detailed terms, limitations and conditions in the agreement will make it more of an enforceable obligation of the landowner but will also make it more difficult to find qualifying financing, and, conversely, a simple subordination agreement giving the developer maximum flexibility to arrange financing may not be enforceable when the time arrives.[19]

§ 1:5.2 Partial Subordination

Leasehold financing can be made more palatable to the tenant and mortgage lenders without subordination of the fee. For example, some or all rent may be deferred or waived if the leasehold mortgagee forecloses. At one extreme, all rent might be forgiven until the lender has recovered all amounts due under the loan; the lender would still be unable to acquire title to or sell the fee. At the other extreme, only a portion of rent may be deferred (for example, any indexed increases in minimum rent) and only for a limited period, after which all arrears would be payable with interest or the lease could be terminated by the landowner. Between the extremes there is an enormous range of potential terms that may be negotiated to facilitate an agreement between the landowner, the developer and the leasehold lender without the "subordination" of the landlord's fee.[20]

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19. *See infra* section 5:4.
20. *See infra* section 6:3.

§ 1:6 Other Issues

There are, of course, many other legal and business issues involved in developmental ground leases. Appendix A is a complete form of ground lease for a large development project, but there are no boilerplate or standard forms (or, there shouldn't be). These are complex transactions that require a high degree of attention, skill and professional experience to execute; but there is good reason to believe that a well-drafted lease can serve as the basis of a successful project. Some of the other potentially contentious issues are:

Subletting and Assignment. These are two separate subjects that are often unfortunately treated as one, sometimes resulting in provisions applying to both that are inappropriate for one or the other. In a ground lease, subletting is the process by which the tenant/developer leases the project to occupancy tenants; he will need the ability to sublet freely. Assignment is the process by which the developer finances or sells the project. The standards governing each need separate consideration. The leasehold mortgage provisions must permit assignment to the mortgage lender and additional assignments in connection with foreclosure or other realization proceedings, and then again by any subsequent owners of the leasehold estate following foreclosure.

Commencement. The increasing complexity of real estate development in general (environmental clearances, "creative" financing, competitive leasing markets) usually means that signing the lease will satisfy only one of many requirements for proceeding with construction. There can be a period of months or even years after execution of the ground lease during which the tenant's ability to proceed may be in doubt, creating related questions of commitment, liability, rental, and costs.

Permits and Approvals. The ground lease will require the tenant to obtain all of the permits and approvals required for development of the tenant's project from governmental authorities, private utilities, and the like. Because the tenant does not hold the fee interest, the landlord's cooperation is essential. Frequently, the fee owner may be asked to compromise some of the rights associated with ownership of the property (even some of the land itself) in order for the tenant to obtain the necessary permits, approvals, and other rights.

Damage and Destruction. The tenant may have substantial equity value in the premises that will be lost if the ground lease is terminated. In the event of a casualty, that equity may only be retained by reconstruction of improvements, whether or not insurance proceeds are available; however, the tenant cannot unconditionally commit itself to repair or replace the improvements (for instance, in the event of an uninsured casualty). Mortgage lenders may also be reluctant to

agree in advance to allow insurance proceeds to fund repairs, especially if occupancy by rent-paying subtenants upon completion is not assured.

Standards. In a long-term ground lease, the landlord is almost wholly passive with respect to the property, which is in the possession and control of the tenant. Only the standards set forth in the ground lease will provide the landlord with some assurance that the construction, operation, and maintenance of the property and improvements will be sufficient to produce rent for the landlord and protect the value of the landlord's reversion upon expiration of the term.

Surrender. The landlord should be concerned with the "boilerplate" in the lease describing the property that will revert to the landlord upon expiration or earlier termination of the ground lease. In the last years of the lease term, the tenant will be resistant to investment in maintenance of the premises, no matter what the lease may require. The property upon reversion should be in a condition and include the fixtures, equipment, and personal property that are necessary to uninterrupted operation of the premises.

Rights to Purchase. The tenant will always want the option to purchase the fee at some point during the term, but most ground lease landlords will not agree to be obligated to sell. But if at some point the landowner or her heirs decide to sell, the tenant reasonably should have the first right to purchase. The landlord may want the same rights if the tenant decides to sell the leasehold, but that is a more complex transaction, involving not a fee subject to a ground lease (which is virtually a financial instrument), but an operating project with multiple variables affecting current value.

Bankruptcy. The U.S. Bankruptcy Code allows each of the landlord and the tenant, if they are subject to a bankruptcy proceeding, to reject the ground lease, which may in either case result in termination of the lease, to the detriment of the other and to third parties, such as lenders and subtenants. Provisions in the lease can guard against this result, and such provisions are usually required by lenders financing a leasehold project and by major tenants.

§ 1:7 Start-Up Problems: Agreements to Agree

Most ground leases for prospective development projects are entered into prior to the "commencement" of the term. The ground lease is executed at a relatively early stage in the development process in order to assure the developer that the land will be available for the project. The term of the lease may not commence until some later date when the developer has obtained permits and financing and has satisfied the other conditions required to proceed with development

of the project.[21] The actual commencement date of the ground lease term may be as late as commencement of physical construction of the project.[22]

The underlying problem with the ground lease for the developer is simply that someone else (that is, the landowner) continues to hold legal title to the land, even though the developer may have the sole possessory right to the property. This affects the permit process (the owner of the property may be required to participate in permit applications and consent to various conditions relating to permits), financing (either when the fee is to be mortgaged and the landowner is a legally indispensable party or, with a leasehold mortgage, when certain accommodations and acknowledgments from the landowner to the lender may be required), securing subtenant relationships with occupancy tenants, approval of plans and specifications, approval of equity investors, and, perhaps, approval of the general contractor or the terms of construction contracts. It is common that, after signing the lease and before commencement, the tenant/developer will need to ask the landowner for some agreement, lease amendment, certification, or other accommodation that she is not obligated to grant under the existing lease. In effect, the most important aspects of development prior to commencement of construction become subject, to one extent or another, to the participation or approval of the landlord.

§ 1:7.1 Pre-Development Expenses

Often, the developer is incurring expenses and making commitments to third parties even while the ground lease is being negotiated. In a large project, architect's and engineer's fees alone may exceed a million dollars. A cautious landowner in these circumstances will put the developer on notice that proceeding with plans, specifications, and other project-related expenses prior to completion and execution of the ground lease will not create any rights in the developer to the property by promissory estoppel or otherwise.[23] The developer will be concerned that the ground lease is signed at a sufficiently early stage so that substantial development expenses are not being expended for a project to be located on property in which the developer has no legal interest.

§ 1:7.2 Unanticipated Conditions

Almost inevitably in the process of bringing a project to the point where physical construction can begin, the developer will need to ask

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21. *See infra* section 8:1.2.
22. *See infra* section 8:5.
23. *See, e.g.*, *infra* section 1:8.1 and Appendix E, paragraph 14.

the landlord for some accommodation (for example, approval of a material change in design or amendments of the ground lease to obtain financing, or some concession to a permitting authority) that, under the terms of the most perfectly drafted ground lease, the landlord will have no obligation to grant. Particularly in the preconstruction phase of development, every commercial real estate project has its surprises. The developer must understand that the ground lease, at least prior to the commencement of construction, will almost always be to some extent potentially an "agreement to agree," which may not be fully enforceable in a court of law.[24]

There is no way to eliminate this possibility, no matter how well-drafted the lease may be, although a well-prepared ground lease is one key to reducing the risk. The developer needs to know and remember that, even though he has reached agreement with the landowner and they have both signed a long and complicated lease document, it is more likely than not that at some point he will have to go back for a further accommodation from the landowner. The developer may then be primarily dependent upon the landowner's continuing desire to see the project go forward with the developer on the same terms and conditions; he will usually not be able to rely upon any legally enforceable commitment of the landlord to agree to the changes that are then needed for the project to proceed.

§ 1:8 Letters of Intent

§ 1:8.1 Legal Context

Preliminary agreements may fall into any of three categories:

(1) a wholly nonbinding term sheet intended merely to summarize the status of ongoing negotiations;

(2) an agreement in principle with other terms still to be agreed upon but with a mutual commitment to negotiate in good faith to reach final agreement; or

24. The most common issues are changes to the project design approved by the landlord due to the demands of permitting authorities or prospective lenders or occupancy tenants; and ground lease changes requested by lending or equity financing sources (*see infra* section 6:7.2, at n.59). Some of the likely problems should be addressed in the ground lease: permit conditions imposed by governmental agencies (*see infra* section 10:2); approval of loan documents where the landlord has agreed to subordinate the fee (*see infra* section 5:9); and disputes regarding approval of design documents (*see infra* section 10:5.4).

(3) a binding agreement where more formal documentation is desirable but not essential.[25]

Courts "uniformly state that the intent of the parties governs the interpretation."[26] But a preliminary agreement is inherently ambiguous as to intent, where all the legally essential terms of a transaction may be set forth in a document signed by the parties that is not intended to be final.[27] A writing need only identify the premises, and state the term and the rental in order to create a tenancy; but many more detailed provisions are needed to create a viable ground lease.

From a legal standpoint, the distinction between a lease and a contract to lease may be elusive.[28] The question should be, in any sort of preliminary agreement, whether the parties intended that the definitive lease include any material term not yet agreed upon. If so, then no contract exists.[29]

A letter of intent or other preliminary agreement will not serve as a sufficient writing to create a long-term ground lease under many state

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25. Homburger & Schueller, *Letters of Intent—A Trap for the Unwary*, 37 REAL PROP. PROB. & TR. J. 509, 513 (2002) [hereinafter Homburger & Schueller]; Channel Home Ctrs. v. Grossman, 795 F.2d 291, 298–300 (3d Cir. 1986); TIAA v. Tribune Co., 670 F. Supp. 491, 497–98 (S.D.N.Y. 1987). *See generally* Poindexter, *Letters of Intent in Commercial Real Estate*, 28 REAL EST. L.J. 195 (2000); Donald Horvath & Randel Waits, *Letters of Intent*, NEGOTIATING COMMERCIAL LEASES, PLI Course Handbook, New York, Fall 2006 [hereinafter Horvath & Waits]; Deborah J. Ludewig, *A Pragmatic View of Term Sheets and Ancillary Agreements*, DRAFTING CORPORATE AGREEMENTS 2010, PLI Course Handbook No. 22488; John S. Hollyfield, *Letters of Intent (With Sample Clauses)*, 25 PRAC. REAL EST. LAW. 33, no. 5 (Sept. 2009). For an instance of category (3), see First Nat'l Mortg. Co. v. Federal Realty Inv. Trust, 631 F.3d 1058, 1066 (9th Cir. 2011).
26. Homburger & Schueller, *supra* note 25, at 518. *First Nat'l,* 631 F.3d 1058 at 1064–65.
27. *Id.* at 513–15; *TIAA*, 670 F. Supp. at 499; Gosfield, *The Structure and Use of Letters of Intent As Prenegotiation Contracts for Prospective Real Estate Transactions*, 38 REAL PROP. PROB. & TR. J. 99, 130–36 (2003) [hereinafter Gosfield]. For an "agreement in principal" that was certainly not intended to be final, but nevertheless served as the basis of an enormous jury verdict for interference with contractual relations, see Texaco, Inc. v. Pennzoil Co., 729 S.W.2d 768 (Tex. Ct. App. 1987). For a signed "Final Proposal" for a ground lease that at least the tenant did not believe was binding, but resulted in a $15,900,000 judgment, see *First Nat'l*, 631 F.3d 1058.
28. MILTON R. FRIEDMAN, FRIEDMAN ON LEASES (5th ed., Patrick Randolph, ed. 2005), § 34:1 [hereinafter FRIEDMAN ON LEASES].
29. *Id.* § 34:2, at n.24. There are really two requirements to be met to create a binding agreement: first, whether all essential terms are sufficiently defined so as to create an enforceable contract (*see* Annotation, *Certainty of Terms in Agreement to Lease*, 85 A.L.R.3D 414 (1978)); and, second, whether the parties intended to be bound by the writing. 1 CORBIN ON CONTRACTS § 2.8 (Rev. Ed. 1993).

laws that often require formalities such as acknowledgments and recording, although partial performance or other theories might take it out of the statute of frauds.[30] A letter of intent not otherwise binding may be made so, at least in part, by promissory estoppel, that is, justifiable reliance by the party seeking to enforce the agreement.[31] The letter of intent may not be specifically enforceable, but reliance may create a claim for damages, at least to the extent of the expenses incurred by the disappointed party.[32] More to the point, preliminary agreements are virtually never intended to create a fully binding long-term ground lease, even though the essential terms may be stated sufficiently to create a lease (for example, term, rent, etc.); the complete, detailed agreement is almost always required as a basis for the tenant's project (for example, for financing).[32.1]

The proper purpose of a letter of intent in a ground lease transaction is to determine if the parties have reached sufficient agreement on the principal business terms of the transaction to justify undertaking the expensive exercise of drafting the definitive agreements;[33] neither the landowner nor the developer should be trapped into any commitment that he or she did not fully understand. The letter should be explicit about any legal commitment that the parties intend to

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30. Homburger & Schueller, *supra* note 25, at 529–30; Gosfield, *supra* note 27, at 139–41; *TIAA*, 670 F. Supp. at 502.

31. Homburger & Schueller, *supra* note 25, at 515; *TIAA*, 670 F. Supp. at 502; Quake Constr., Inc. v. Am. Airlines, Inc., 565 N.E.2d 990, 1005 (Ill. 1990). A letter of intent conditioned on "execution of a definitive agreement satisfactory in form and substance" to both parties precluded promissory estoppel. Prospect St. Partners I, LLC v. Eclipsys Solutions Corp., 804 N.Y.S.2d 301, 302 (2005). But under a letter of intent that did not create an obligation to negotiate in good faith under Iowa law, various oral assurances that the deal would proceed allowed a promissory estoppel claim to be submitted to a jury. Budget Mktg., Inc. v. Centronics Corp., 927 F.2d 421 (8th Cir. 1991).

32. Gosfield, *supra* note 27, at 141–44; RESTATEMENT (SECOND) OF CONTRACTS § 90 (1981). Promissory estoppel would support a claim for "reliance damages." *Budget Marketing*, 927 F.2d at 426–28. Damages for failure to negotiate in good faith limited to out-of-pocket expenses and "lost opportunity costs," but not lost future profits. Copeland v. Baskin Robbins USA, 117 Cal. Rptr. 2d 875, 885–86 (Cal. Ct. App. 2002).

32.1. In *First Nat'l*, 631 F.3d 1058, the parties signed a one page, nine paragraph "Final Proposal" for a ground lease to develop a multiuse project that was "subject only to approval of the terms and conditions of a formal agreement." *Id.* at 1063. The tenant prepared a draft lease, but further negotiations led to disagreements. The Final Proposal did not say it was not binding and omitted the tenant's "standard non-binding clause" that was in earlier drafts. *Id.* at 1065. The jury was allowed to find that the parties intended a binding agreement, and the plaintiff/landowner received damages representing the benefit of its bargain for lost rentals and breach of a put option. *Id.*

33. *See* Horvath & Waits, *supra* note 25.

create and otherwise provide that the letter is not intended to be binding.[34] These matters should not be left to later interpretation.

If it is intended that a preliminary agreement is merely a nonbinding term sheet, it probably should not be signed by the parties. An unsigned term sheet is sufficient to set forth the state of negotiations; execution by the parties seems to signify something more.[35] An obligation to negotiate in good faith may be implied under state law unless the agreement specifically and clearly provides otherwise.[36] Often the purpose of a letter of intent is for the developer to tie up the land and the landowner to the extent practicable during the lengthy and expensive process of fully documenting the transaction. This may be required to assure the prospective developer/tenant that the time and expense of pursuing the deal are worthwhile.[37]

The parties should consider their obligations if the tenant finds an alternative site or if the landlord receives another offer. If a "no-shop" obligation is intended to bind one party, it might be made to obligate both, although most developers would consider that unacceptable. A no-shop clause that binds the landowner (but not the developer) for a reasonable, limited period should be acceptable.[38] Even if the parties intend that a particular term in a preliminary writing shall be binding, it may still be unenforceable if it is not sufficiently definite, or for a failure of consideration, or for other reasons (for example, as against public policy).

A letter of intent may also create a liability for the landowner to her real estate broker if the transaction falls through, depending on the

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34. *See infra* Appendix E, paragraph 14. As a matter of interpretation, it seems that any preliminary writing that contemplates a definitive agreement should be presumed not to be binding, except for those terms that by their nature must apply before the definitive agreement is reached, or as the parties otherwise specify.
35. Homburger & Schueller, *supra* note 25, at 529, 531. But if any terms of the letter are intended to be binding, then signatures will be required.
36. Gosfield, *supra* note 27, at 145; Channel Home Ctrs. v. Grossman, 795 F.2d 291, 298 (3d Cir. 1986); *TIAA*, 670 F. Supp. at 491, 496; FRIEDMAN ON LEASES, *supra* note 28, § 34:2. The Illinois cases are apparently more hostile to the "good faith" obligation: Feldman v. Allegheny Int'l, Inc., 850 F.2d 1217 (7th Cir. 1988); Empro Mfg. Co. v. Ball-Co Mfg., Inc., 870 F.2d 423 (7th Cir. 1989); Berco Invs., Inc. v. Earle M. Jorgensen Co., 861 F. Supp. 705 (N.D. Ill. 1994).
37. Even if this is specifically intended and stated, the "no-shop" clause may still not be enforceable if it does not meet contract law requirements. In Officemax, Inc. v. Sapp, 32 F. Supp. 2d 1079 (M.D. Ga. 2001), the no-shop agreement failed for lack of consideration (because the letter did not create any legal obligation on the tenant) and because it lacked an essential term (duration).
38. *Cf. infra* Appendix E, paragraph 9. The developer's agreement to undertake certain actions and expenses in pursuit of the project will usually constitute sufficient consideration.

terms of the listing agreement and the factual circumstances (for example, if the landowner decides to take another offer).[39] The landowner should consider a side agreement with her broker if he brings a preliminary agreement for her to sign. Generally, a letter of intent or other preliminary agreement will merge into the ground lease when fully executed.[40]

§ 1:8.2 Preliminary Agreement for a Ground Lease

If the developer is attempting to tie up the land in "good faith" negotiations, the landowner should want the extent and duration of her obligations well defined or she may face an extended period of uncertainty (or litigation) concerning her ability to do anything else with the property. In this context, any or all of the following should be in a letter of intent:

(a) The material terms (rent, term, etc.) to the extent agreed upon.

(b) A statement that no lease will be created until execution and delivery of a definitive lease document by both parties.

(c) A statement that the costs of due diligence and other preliminary work by the developer are solely at the risk of the developer and will not create any obligation on the landowner in the absence of the definitive agreement.[41]

(d) Extent of exclusivity, if any: may the landowner solicit or entertain other offers? Back-up offers? The agreement should presumably prohibit any other lease or other disposition of the property during its term.

(e) A specific date by which the definitive ground lease should be completed or the preliminary agreement will terminate.

(f) Any duty to negotiate in good faith (which may be implied unless the agreement states otherwise).[42] If it is intended that either party may terminate negotiations at any time for any reason, the agreement should say so. If it is intended that the developer (but not the landowner) has the discretion to terminate based on due diligence or project feasibility, the letter

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39. Homburger & Schueller, *supra* note 25, at 512–13; Realty Investors of USA, Inc. v. Bhaidaswala, 679 N.Y.S.2d 179, 181 (App. Div. 1998); E. Kendall Invs., Inc. v. Bankers Real Estate Partners, 742 So. 2d 302 (Fla. Dist. Ct. App. 1999).
40. *See, e.g.*, Farley Inv. Co. v. Webb, 617 A.2d 1008 (Me. 1992).
41. Gosfield, *supra* note 27, at 138; *see infra* Appendix E, paragraph 14.
42. *See supra* note 36.

should say so. Similarly, the letter should state if there is any restriction on the prospective tenant from investigating or entering into any arrangement for any alternative site prior to formal termination of the letter (a restriction that few developers would accept).

(g) If the landowner requires a deposit or other payment for holding the property available while the developer determines whether he can go ahead, then the terms of payment (and repayment, if any) should be spelled out. The terms might be different, for instance, if there is a fatal problem with the property, for example, title defects or hazardous materials, than if the developer decides not to proceed for whatever reason.

(h) Access to the property for due diligence, for example, soils and environmental testing; indemnification and insurance requirements for the pre-lease period. Indemnification obligations should survive termination of the letter of intent.

(i) Disposition of documents and reports if the transaction is terminated. The landowner should want at least copies of surveys, title, soils, and environmental studies.

(j) Responsibility for brokerage commissions (presumably only in the event the lease is completed), with cross indemnities against other claims.

(k) Prohibition on assignment by either the developer or the landowner; although the developer may need to use a special entity as the tenant under the definitive ground lease.[43]

(l) Choice of law; the letter of intent need not be subject to the law of the state where the property is located, even though the ground lease will be.

(m) Confidentiality of proprietary information of either party provided to the other in the course of the negotiations, for example, financial statements of the developer; mutual consent for press releases.[44]

43. *See infra* section 13:5.1.

44. There may be little need for a confidentiality agreement for the landowner, but some developers may think they have valuable proprietary information to protect. A detailed confidentiality and nondisclosure agreement may be appropriate, if at all, before the letter of intent stage. *See* Ludewig, *supra* note 25, at 8. The letter of intent in a real estate deal will more likely address matters of premature publicity.

(n) Finally, distinguish what is intended to be binding and what is not. A letter of intent might specify that only specific items are intended to be enforceable, and that the letter is otherwise nonbinding.

Appendix E is a sample letter of intent for the ground lease that is Appendix A. Note that paragraph 14 of Appendix E has an alternative provision specifically denying any obligation to negotiate in good faith. An unsigned term sheet might be less discouraging to subsequent negotiations than insertion of this clause.[45]

§ 1:9 Role of Counsel

Contemplating the deadly price paid in the search for the Maltese Falcon, Sam Spade (Bogart) says to Miss O'Shaughnessy (Mary Astor): "I can't go ahead without more confidence in you than I've got now. You've got to convince me that you know what this is all about, that you aren't just fiddling around hoping it will all come out right in the end."

Some of our clients might say something of the sort to us. It is the role of counsel in any business matter to provide thoughtful advice based upon an understanding of legal and related requirements for the successful completion of the transaction. A ground lease introduces a host of complications (many of them essentially legal in nature) to an already complex process. Counsel to each of the parties needs to anticipate these difficulties; with foresight we may satisfy requirements before they become problems, avert costly detours down blind alleys, and avoid commitments that cannot be met.

It is the purpose of this book to provide a framework for analysis of the effects produced by ground leases, from initial project planning through construction, financing, operation, and eventual sale, and to suggest means to eliminate or manage the attendant risks. As the Fat Man (Sydney Greenstreet) would say, "Here's to plain speaking and clear understanding."

§ 1:10 Sources and Terminology

This discussion assumes the reader has a working knowledge of landlord-tenant law (and, for that matter, real property security and basic real estate development). Federal income tax considerations are noted occasionally but no attempt has been made to suggest answers in the shifting federal tax environment. Landlord-tenant law is subject

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45. For a more nuanced, perhaps less offensive, clause, see Hollyfield, note 25, *supra*, at 36.

to innumerable local variations; where needed, the footnotes refer to Milton R. Friedman, *Friedman on Leases* (Patrick Randolph, ed., PLI 2005) (hereinafter FRIEDMAN ON LEASES) for a description of local law considerations.

In the following pages, "developer" and "tenant" are used interchangeably, as are "landlord," "landowner," "groundowner," and similar terms. The pronouns used to refer to either are usually "her" for the landowner and "him" for the developer, a purely arbitrary convention. "It" might have served with greater accuracy, but it is important to personify the players: The decisions and interests of human beings are at stake, even when the nominal parties are corporations or other legal fictions.

It is hoped that the terms used will reflect contemporary understanding without being particularly technical. The term "mortgage" is used almost exclusively, although the instrument is usually a deed of trust. The term "construction loan" will not be defined. "Take-out financing" usually refers to a term mortgage loan, but also has room to include many kinds of equity commitment. "Term loan" is the phrase that describes what was once called a "permanent loan." The "property," "land," "premises," "leased land," "demised premises," and similar terms all mean the same thing; "project" and "improvements" are something more.

Finally, "occupancy tenants" and "occupancy subtenants" and sometimes "subtenants" are used interchangeably to refer to that very important creature: the rent-paying occupant and user of the project, who the lawyer must always remember is technically and sometimes troublesomely a subtenant (and is sometimes the lawyer herself).

§ 1:11 Conveyance or Contract?

Many decades ago, when the author was in law school, leases were described as occurring at the intersection of contract and property law. A great deal of academic scholarship has been devoted in the past half century (at least) to the issue of whether a lease of real estate is a conveyance—as it was in the misty beginnings of the common law—or, in these "modern" times, more of a contract. As *Friedman on Leases* observes, in residential leases today, contract principles generally control and regulatory statutes have increasingly occupied much of the field.[46] Even most commercial leases now involve occupancy by the tenant of space in a building or other development substantially dependent on the landlord or its agent to provide virtually all essential services to make the leased premises usable by the tenant, so that

46. FRIEDMAN ON LEASES, *supra* note 28, § 1:2.1.

possession is merely one feature of the bargain.[47] However, even then there are few statutory protections for the tenant, and the extent to which the tenant may be entitled to recourse against the landlord will usually depend on the lease document itself and the development of common law in the jurisdiction. As *Friedman on Leases* observes, the rule that covenants in a lease are independent and not mutually dependent is a distinguishing characteristic of a lease rather than a contract,[48] so that the tenant may be liable to continue paying rent even if the power is interrupted, again, depending on the terms of the lease and the state of the local common law.[49]

In today's commercial real estate, the ground lease is something of an anachronism in that it is usually much more like a conveyance than a contract, and most developer/tenants are much more capable of dealing with independent covenants than most commercial tenants (for whom real estate is usually not a specialty). Many groundowners are employing a ground lease in order to create a secure annuity. Most ground lease landlords expect the tenant to deal with whatever complexities arise during the course of the lease and do not expect to have any significant affirmative obligations to the tenant for most of the term of the lease. The notion that there may be mutually dependent obligations in the ground lease is not often important and sometimes may introduce an element of mischief. If the ground lease rent payment is late, would the tenant forfeit a right to renew?[50] It is possible that the "development" of "modern contract" principles in commercial lease law may frustrate the expectations of the parties to a ground lease who relied on the state of the common law at the time the lease was negotiated and signed.[51]

There is little protection against this risk except to create a ground lease that does not rely on outstanding case law (or statutes, for that matter) but makes specific provision for the obligations of the landlord and tenant for all the important issues in their relationship, even though this may involve more words than our clients want to pay for. Throughout this book the reader will find discussions of issues involving developing or mixed rules of law, of majority and minority rules and the like, concluding with the admonition that these matters should not be left to later interpretation. In a "lease contract" that is expected to last for decades, if there is any doubt, spell it out.

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47. *Id.* § 1:2.2.
48. *Id.*
49. *See, e.g.*, John V. Orth, *Leases: Like Any Other Contract?*, 12 GREEN BAG 2D 53 (Autumn 2008); Bogart, *supra* note 13, at 55–56.
50. FRIEDMAN ON LEASES, *supra* note 28, § 1:2.1.
51. For an example of this in the context of the landlord's obligation to consent to assignment by the tenant, see *infra* section 13:4.1.

§ 1:12 A Case Study: The Developer's Form Ground Lease

Some developers use ground lease forms as a basis for developments, usually for smaller projects with a single anchor tenant, such as a grocery or drug store, in desirable locations where the groundowner is reluctant to sell. (The projects may also be for other uses, such as motels or small hotels, self-storage facilities, or the like.) The lease forms are generally individualized to the developer, but tend to a pattern.[52] The developer will assure the landowner that there will be no "subordination of the fee,"[53] but argues that the form lease must be used substantially as presented in order to assure financing for the project.[54] The landowner usually hopes to establish a secure, long-term income stream for herself and her family. The developer typically plans to develop the property in the immediate future for use by a specific tenant, often with additional "spec" space. But the terms of these form leases sometimes give the developer/tenant an additional bundle of rights that have little to do with the specific initial project—and some of these lease terms may provide the tenant with virtual fee ownership.

The initial development is likely to have a useful economic life of twenty-five years or so, and not much more. However, the form lease may allow the developer to redevelop the property at any time and for any legal use, and to extend the term, at a basic rent subject only to limited increases, for thirty or forty years or more after the initial term. The minimum rent adjustments provided for in the lease will likely result in a rent after the initial twenty or thirty years that is substantially less than the fair rental value of the property. After another thirty or forty years, the rent may be only a cruel reminder to the landlord's descendents of the poor business deal she made. Of course, if the property cannot be profitably redeveloped after the initial term or if the rent is not attractive, the developer/tenant will simply let the term expire.

When presented with one of these form ground leases, the following terms (among others) deserve careful consideration by the landowner and her advisors.

Initial Term. The initial term is usually fairly short, twenty to thirty years, but with multiple options to extend for additional five or ten year intervals, to a total of fifty or more, even one hundred years.

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52. For one typical form, see Senn, *Ground Lease (Sample), in* COMMERCIAL REAL ESTATE LEASES, SELECTED ISSUES IN DRAFTING AND NEGOTIATING IN CURRENT MARKETS, COURSEBOOK (ALI–ABA 2008).

53. *See infra* section 4:4.

54. Usually, the developer plans to use the ground lease in much the same form with the same anchor tenants, equity investors, and lenders as in similar prior projects, helping to alleviate the time, expense, and general brain damage associated with reviews of highly negotiated ground leases. *See supra* section 1:3.5, at note 13.

The potential term will far exceed any expected useful life of the initial project. Options to extend will, of course, be solely in the control of the tenant.

Preconstruction. The tenant/developer will not be committed to the lease until project construction actually begins and may be permitted long delays while continuing to tie up the property without the payment of rent. Some forms may not require the tenant to pay even real estate taxes until construction is completed. Typically, the tenant has no obligation to develop, or even to use good faith efforts to pursue development, but the lease may allow for demolition of existing improvements, termination of existing tenancies, rezoning of the site and other consequential acts, still without committing the developer to the lease or development of the project, or any reimbursement or compensation to the landowner.

The Tenant. Almost always, the "tenant" will be a limited liability company or other newly formed, single purpose entity with no appreciable assets, and that is controlled by the actual developer entity. The developer will avoid any liability on the lease. The tenant's indemnification of the landlord against claims arising from development activities is unfunded, except to the extent of insurance effectively covering the landlord.[55] Effective public liability insurance will still not protect the landlord from labor or material lien claims against the property for preconstruction work when the project is abandoned by the developer and its shell tenant.[56]

Rent. Basic rent is fixed with periodic (for example, every five years) increases in a set amount (commonly a simple one percent/annum). With "acceptable" inflation of 2%–4%, and no other adjustments permitted under the lease,[57] this provision virtually guarantees that the rent after twenty years will be materially less than the then market rental value, and will only be a small fraction of market rent after fifty years or more.

Planning and Permitting. The ground lease form will require the landlord to join in the permitting process or authorize the developer to act on her behalf, even though no set plans or use of the property is required by the lease. If the landlord has other property in the vicinity, this may be doubly problematic. Typically, the lease provides the landlord no review or approval of plans or specifications for the project, but will require the landlord to execute and deliver instruments that the tenant deems necessary for permits, zoning, easements, dedications, CC&Rs, etc.[58]

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55. *See infra* sections 8:1 and 14:4.
56. *See infra* section 8:3.1.
57. *See infra* section 2:4.
58. *See generally infra* chapter 10.

Landlord Warranties. Usually, the form ground lease will create unlimited personal liability of the landlord with respect to warranties of title[59] and hazardous materials.[60]

Use. The form lease allows the tenant, without the consent of the landlord, to use the property for any lawful purpose from time to time during the term, and to alter, demolish, and construct improvements from time to time. For instance, if, after twenty years, the strip center site can be used for a high-end multipurpose project, then the tenant is free to redevelop the site while continuing to pay the same rent to the landowner.[61]

Assignment. Typically, the tenant is allowed to freely assign the ground lease at any time without the consent of the landlord and then to be released from any further liability under the lease.[62]

Non-Disturbance. The landlord is normally required to join in non-disturbance agreements with subtenants on terms proposed by the developer. This could result in the liability of the landowner to the subtenant in the event the ground lease is terminated for defaults of the developer under the sublease. At best, the landowner might find herself the owner of a project after the developer has walked away, subject to an occupancy lease that likely contributed to the failure (many anchor tenants expect to be subsidized by the developer in terms of below cost occupancy expense, which the developer hopes to recover from the smaller satellite stores).[63]

Landlord Financing. The form lease may prohibit the landlord from creating any liens against the fee interest, even if specifically subordinated to the ground lease—in effect prohibiting (unnecessarily) any financing of the landlord's rental income stream.[64]

In general, the form leases are often not very demanding of the tenant with respect to many (secondary) matters, including insurance, construction bonds, rebuilding after a casualty, curing defaults, and the like, and may be dismissive of the landlord's concerns in certain matters, such as condemnation proceeds. The heart of the matter, however, is that the usual developer's form ground lease gives to the developer/tenant the long-term control of the property and the ability to realize any substantial increase in its value, while continuing to pay a strictly limited basic rent to the landowner. The terms creating this position go well beyond the rights required for the initial project, and have substantial value to the owner of the leasehold estate. The many

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59. *See infra* section 9:2.6.
60. *See infra* sections 9:2.2 and 9:2.5.
61. *See infra* sections 2:5.1 and 2:6.
62. *See infra* section 13:5.
63. *See infra* section 12:7.1.
64. *See infra* section 4:7.

extensions of the term beyond the useful life of the original improvements (with only nominal rental adjustments) and the rights to change the use and redevelop as the tenant sees fit take from the landowner the long-term ownership of the fee in everything but name, with no corresponding benefit to the landowner or burden on the developer. In most cases, the initial tenant/developer will sell the leasehold after completion of the initial project, sometimes to an affiliate of the prime tenant. That sale will be facilitated, and the price enhanced, by the inclusion to purchasers of this additional long-term redevelopment potential.

It should be noted at this juncture that these issues can be addressed if the parties are inclined to do so. A percentage rent clause with appropriate adjustments for changes in use might address these concerns, but the complexities of percentage rent usually cause the parties to reject this approach,[65] especially for a relatively small project. Periodic reappraisals of the basic rent following the end of the useful life of the initial project, or upon any substantial change in the use or development of the property, would also address the problem.[66] The suspicion, however, is that the developer is not really interested in solving this problem, but rather intends to acquire this enhanced position at the expense of relatively unsophisticated landowners anxious to obtain a secure source of income.

Developers have a legitimate concern that a standard form lease will help to facilitate relatively small projects that cannot afford extended negotiations among the landlord, the developer, occupancy tenants, lenders, and investors. However, that objective could be achieved with a "fair and balanced" form of lease that is not calculated to take advantage of the landowner.

§ 1:13 Hawaii Ground Leases

Ground leases are in widespread use in the state of Hawaii, both for residential and commercial properties. Here the problem is usually not developer/tenants preying on unsophisticated landowners; rather, a small number of dominant landlords have established a leasehold regime that requires the resetting of ground rents during the useful lives of many tenant-built projects at the expense of both residential and commercial tenants. In the late 1980s the federal government and the State of Hawaii owned about 49% of the land in Hawaii, and seventy-two large landowners held 47% of the rest.[67] Twenty-two

65. *See infra* chapter 3.
66. *See infra* section 2:6.
67. Richardson v. Honolulu, 124 F.3d 1150, 1154 (9th Cir. 1997). The largest eighteen landowners held 40% of the available land.

landowners owned 72½% of the land on Oahu (the island home of Honolulu and more than 70% of the state's population) not owned by government.[68] Many of the largest landowners were and are trusts and estates, many of which are charitable and benefit Native Hawaiian and/or disadvantaged groups in the local population.

By the middle of the twentieth century a widespread practice of ground leasing by Hawaii's private landowners had become established. In many cases, this seems to have resulted from restrictions on sale contained in the governing instruments of estates and trusts, and sometimes from income tax issues.[69] By the 1960s and 1970s, ground leases were used predominantly for both commercial (hotels, shopping centers, and industrial buildings) and residential development (apartments, planned unit developments, condominiums, and even single-family homes). The typical ground lease, whether residential or commercial, is unsubordinated, runs for fifty to seventy-five years, with a fixed or step rent for the first twenty to thirty years, and then "renegotiation" for every ten or fifteen years thereafter. The renegotiation usually requires a new ground rent calculated as a percentage (for example, 6%–10%, or perhaps at a "market" rate to be determined at the time of the adjustment) of the then "unimproved and unencumbered" land value. Some of the earliest leases underwent "renegotiation" in the 1980s and thereafter, and resulted in dramatic increases in ground rents.[70]

One common theme in the renegotiation of ground rents has been the scarcity of fee property for value comparison. As a result of the concentration of ownership of fee property in the state, there is relatively little fee property available for purchase, especially in prime development areas around Honolulu. As a result, there is likely a premium to be paid for fee property that becomes available. In leasehold rent valuations, comparable sales are a primary indicator of value. Thus, the leasehold system, which limits the availability of fee property, in effect also raises the values used to set ground rents,

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68. Green, Note, *Anthony v. Kualoa Ranch, Inc., Statutory Requirement to Purchase Residential Leasehold Improvements is Unconstitutional as Applied Retroactively*, 10 U. HAW. L. REV. 419, 425 n.43 (1988) [hereinafter Green].
69. *Id.* at 425 n.45. For historical background, see *id.* at n.42.
70. The evidence is mostly anecdotal. One report estimated a condominium unit ground rent escalation from $45/month to more than $1,000, which would imply a very low initial valuation followed by very high land value appreciation in the Islands. *See Richardson*, 124 F.3d at 1154 n.2. A hotel ground lease rent in Waikiki at about the same time reportedly increased from $187,000 to more than $3,500,000 as a result of an arbitration proceeding *that the tenant won. See* Alan Weakland, *Hawaiian Hospitality*, FINDLAW (Jan. 1997) [hereinafter Weakland, *Hawaiian Hospitality*], *available at* http://library.findlaw.com/1997/Jan/1/126217.html.

which contributes to the increases in ground rents experienced by tenants. The landowning structure in Hawaii is sometimes referred to as an oligopoly.[71]

§ 1:13.1 Residential Ground Leases

Legislative efforts to ameliorate these effects of the leasehold system have centered on residential leases.[72] The limited availability of fee land for housing, and later ground rent increases that, anecdotally, resulted in people losing their homes, drove several attempts to reform the system. The Land Reform Act of 1967,[73] provided for, among other matters, the conversion of many single family lots from leasehold to fee ownership by the tenant through the state's eminent domain power.[74] Then in 1991, Honolulu adopted an ordinance providing for the conversion of leasehold condominiums to fee, again by use of the power of condemnation.[75] Other attempts by the state and the city of Honolulu were made to improve the relative position of residential ground lease tenants, some successful and some not.[76] From the beginning, efforts to regulate the leasehold system were opposed by the large landowning trusts and their beneficiaries, who are predominantly Native Hawaiian. Kamehameha Schools (formerly known as the Bishop Estate), the largest landowner on Oahu and a charitable trust dedicated to the education of Native Hawaiian children, protested the Honolulu ordinance as discriminatory against Hawaiians, and was the lead plaintiff in challenges to both the Land Reform Act and the Honolulu conversion ordinance.[77]

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71. *See* Green, *supra* note 68, at 422.
72. A typical residential ground lease runs initially to the developer/tenant, who constructs improvements and then sells the units (sometimes lots) to residents (or investors). The "deed" is, in effect, a partial assignment of the ground lease, or assignment *pro tanto* (*see infra* section 12:11) resulting, under the terms of the ground lease, in a direct lease between the landowner and the unit purchaser, and the release from liability of the developer once all the units have been conveyed. Common elements are usually conveyed to a homeowners association.
73. HAW. REV. STAT. §§ 516 *et seq.*
74. The Act, which had the stated intention of breaking up the land "oligopoly," was upheld by the U.S. Supreme Court in Haw. Hous. Auth. v. Midkiff, 467 U.S. 229 (1984).
75. Honolulu Ordinance 91–95 (Dec. 18, 1991), which was also upheld in Richardson v. Honolulu, 124 F.3d 1150, 1154 (9th Cir. 1997).
76. Statutes assured tenants of the right to sell and assign units without landlord approval and to be released from future lease liability. Another act requiring the landlord to purchase improvements upon lease expiration was largely invalidated, *see* Green, *supra* note 68, and a Honolulu ordinance attempting to limit ground lease rent increases was overruled. *Richardson*, 124 F.3d at 1163–66.
77. *Richardson*, 124 F.3d at 1162–63, 1156 n.5.

In 2005, the move to repeal the ordinance, led by large land trusts and their beneficiaries, small landowners (who felt at a disadvantage against tenant organizations) and Native Hawaiian activists, was finally successful. The repeal ordinance, adopted by the Honolulu city council in February 2005, recited that the original purpose of the ordinance, which was to encourage fee ownership of land on Oahu, had been largely accomplished.[78] Kamehameha Schools once owned the land under about 16,000 units on Oahu; fifteen years after the adoption of the ordinance, that ownership was reduced to "a few thousand," and overall the number of leasehold condominium units on Oahu had dropped from about 53,000 to about 19,000.[79] Perhaps as a result of the success of the ordinance, many saw repeal as a victory for continuing land ownership by Native Hawaiians.[80]

Notwithstanding repeal, the problems of leasehold condominiums remain—many older ground leases are now near final expiration. Leases of land under 1,500 units are said to expire by 2018.[81] Homeowners who have occupied their homes for decades may face eviction if the landowners decide to redevelop the properties. Many of those displaced would have limited resources to acquire other housing.

It is likely that residential ground leases are a disappearing phenomenon in Hawaii. The well-publicized problems with leasehold properties have resulted in a resale market where leasehold units are difficult to sell and prices have generally declined relative to fee properties.[82] Several large landowners have continued, on a voluntary basis, to make the fee interest under leasehold units available for purchase, ostensibly to diversify their assets,[83] but perhaps also to avoid problems associated with the ground lease end game.

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78. Honolulu Ordinance 05-001 (Jan. 26, 2005); Matsuda v. Honolulu, 512 F.3d 1148, 1151 (9th Cir. 2008).

79. Allison Schaefers, *Hawaii Residents Face Leasehold Shake-Up*, HONOLULU STAR-BULLETIN, MOBILE ED., Dec. 17, 2007 [hereinafter Schaefers, *Hawaii Residents Face Leasehold Shake-Up*], *available at* http://archives.starbulletin.com/2007/12/17/business/story02.html. In 1997, the City asserted that Kamehameha Schools owned 20% of the condominium units on Oahu. *Richardson*, 124 F.3d at 1154 n.3.

80. Crystal Kua, *Fee Law Repealed*, HONOLULU STAR-BULLETIN.COM (Jan. 27, 2005), *available at* http://archives.starbulletin.com/2005/01/27/news/story5.html; WONG, KA WAI OLA O OHA, OFFICE OF HAWAIIAN AFFAIRS, LEASEHOLD REPEAL PASSES (Feb. 2005).

81. Schaefers, *Hawaii Residents Face Leasehold Shake-Up, supra* note 79.

82. *Id.*

83. Andrew Gomes, *Fee for Waikiki High-Rise Offered*, HONOLULU ADVERTISER, Nov. 10, 2006 [hereinafter Gomes, *Fee for Waikiki High-Rise Offered*], *available at* the.honoluluadvertiser.com/article/2006/Nov/10/bz/FP611100338.html; and Schaefers, *Hawaii Residents Face Leasehold Shake-Up, supra* note 79.

§ 1:13.2 Commercial Ground Leases

Commercial leases have generally not received the attention given to their residential counterparts, at least until recently. Ground leases for hotels in Waikiki and other resort areas, and for industrial/warehouse space, offices, shopping centers, and other uses became common in the 1970s, and largely followed the same pattern used in residential leases, that is, fifty-plus year terms with fair market value rent adjustments beginning at twenty to thirty years, and periodically thereafter. As a result, a number of reappraisals have arisen and will arise in the first decades of the twenty-first century. The high-end hotel market usually demands major property renovations once a decade or more often. While the problems of hotel owners and operators are unlikely to generate much public sympathy, it is likely that there are older properties in Waikiki that have found that financing for expensive upgrades is simply not available due, at least in part, to the ground lease. Many older hotels have recently been converted to time shares and residential condominiums, presumably with the consent of the landowners where the property is subject to a ground lease, creating a concern that Waikiki is losing hotel rooms needed to maintain its prominence as a vacation destination.

Leasehold industrial spaces became an issue in 2007 when a new owner of large chunks of property in Mapunapuna and Lalihi Kai, which are industrial areas near the Honolulu airport, sent rental renegotiation notices to a large number of businesses in the area, with suggestions of very substantial rent increases (generally more than double existing rents).[84] The new owner, a REIT from Massachusetts,[85] had acquired the properties (more than ten million square feet of land) from a private family land trust. An organization of tenants was formed to obtain "fair and reasonable rents" from the "mainland" landlord. Some tenants declared from the start that they could neither afford the higher rents nor could they find affordable replacement property because the supply of industrial fee land is so limited.[86] Like the homeowners who face eviction upon expiration of the condominium ground leases, some businesses may face "economic

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84. Andrew Gomes, *Industrial Strength Fear*, HONOLULU ADVERTISER, Feb. 24, 2008, at F1, *available at* the.honoluluadvertiser.com/article/2008/Feb/24/bz/hawaii802240334.html.

85. A mainlander, "not kama'aina," that is, not local, *see id.* at F2, unlike the Native Hawaiian groups that own much of the land under residential condominiums.

86. *Id.*; Jason Ubay, *Facing Economic Eviction*, HAW. BUS., Nov. 2008 [hereinafter Ubay, *Facing Economic Eviction*], *available at* http://www.hawaiibusiness.com/Hawaii-Business/November-2008/Facing-Economic-Eviction/.

eviction" from facilities that they built and maintained themselves, and have used for decades.[87]

In 2009, the Hawaii state legislature passed an act attempting to define "fair and reasonable rent" as used in most of the ground leases, to mean fair and reasonable to both the landlord and the tenant, taking into account the use allowed by the lease, and the physical characteristics of the property and the neighborhood.[88] Generally, disputed rental rates under the ground leases are set by arbitration, and many tenants argued that "fair and reasonable" required consideration of the tenant's business and ability to pay the new ground rent. The landlord maintains that it simply means fair market value. Presumably, the legislation was intended to support the local tenants against the mainland landlord, but it is not clear how. It may be that the act mandates a "use value assessment" rather than a "highest and best use" valuation, which may be a boon to the tenants if arbitrators so interpret it. But can the legislature change the terms of existing leases, or mandate property valuations between private parties at less than fair market value? In early June 2010, a federal district court in Honolulu, apparently finding that the statute did effect some substantive change in the existing leases, declared the law unconstitutional.[89] There is little sign that the leasehold system for commercial property in Hawaii will undergo any substantial change in the near term.[90]

There is little unique about the Hawaiian leasehold system other than its ubiquity. Hawaii underwent several boom decades from 1958 (after the first Boeing 707 flew in from the mainland) until 1990, when the Japanese stock market collapsed. Since then, tenants, developers, bankers, and condominium purchasers have developed a better appreciation of the typical ground lease—the potentially unlimited periodic rent adjustments and the increasing pendency of lease expirations.

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87. Ubay, *Facing Economic Evictions, supra* note 86.

88. HONOLULU ADVERTISER, July 21, 2009, at B5–B6.

89. HONOLULU ADVERTISER, June 2, 2010, at B5.

90. One large land trust, while offering to sell the fee interests under several Waikiki condominium projects, determined to retain its interest in another condominium located directly across the street from Waikiki Beach and zoned for future hotel use. Gomes, *Fee for Waikiki High-Rise Offered, supra* note 83. In 2008, the State Department of Hawaiian Home Lands offered to lease a commercial parcel in Mo'ili'ili in Honolulu near the University of Hawaii for the usual terms: a twenty-five to sixty-five-year term; $1.2 million per year for the first ten years; minimum rent increases to $2.3 million per year in year twenty; rent after year twenty-five based on land value reassessments. *See* Vorsino, *Bowl-O-Drome Property Remains a Question Mark*, HONOLULU ADVERTISER, Feb. 25, 2008, at B3.

They recognize the problematic nature of the ground lease as commonly structured as a basis for major reinvestment or for long-term residency; increasingly, lenders won't lend and builders can't build.[91] The repeal of the Honolulu conversion ordinance will not assure the Hawaiian land trusts of long-term prosperity unless they adapt their ground lease practices to the realities of the modern investment and lending markets.[92]

91. *See, e.g.*, Weakland, *Hawaiian Hospitality, supra* note 70; LIZA STONE, JEFFER, MANGLES, BUTLER & MARMARO LLP, HAWAII: PITFALLS IN A UNIQUE HOTEL MARKET (Aug. 1997), *available at* hotel-online.com/Trends/Jeffer/Articles/HawaiiPitfalls; Benjamin Neil, *Ground Rents from Maryland to Hawaii: Leasehold Interests in Residential Real Estate*, ENTREPRENEUR.COM, Fall 2006, at 2, 3, *available at* entrepreneur.com/tradejournals/article/157037003; Guide to Leasehold Ownership in Hawaii, REALESTATE-OAHU.COM, *available at* realestate-oahu.com/leasehold_properties_hawaii.php/.

92. For a discussion of minimum rent, see *infra* sections 2:4.2–2:4.7; for a discussion of minimum rent adjustments, see *infra* section 2:5; and for a discussion of renewal rent, see *infra* section 2:6.