It Could Happen

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Over the life of a 99-year ground lease, all kinds of things can happen to the leased property. If one of those things happens, the lease must handle it in a way that makes sense and won't cause an unexpected loss to the landlord, the tenant, or the lender to either of them.

If the lease doesn't address some eventuality, or handles it incorrectly, leaving potential for a gap or a surprise, this can cause concerns later. The lease might not even be financeable. Without financing, it becomes unattractive to purchasers and its value suffers.

I recently identified six provisions that appear in nearly every long-term ground lease, addressing things that could happen. I asked 300 New York City commercial real estate lawyers if they had ever seen any of these things actually happen. I asked for war stories about how they turned out. Here they are:

1. *Contract Assignments.* A ground lease often covers vacant land, which the tenant will develop. Before starting construction, the tenant must assign to the landlord—give the landlord the right to enforce—the tenant's contracts for the project. That way, if the project fails, the landlord can take it over and finish it. How often has a landlord actually taken over a tenant's project, exercised its rights under the contract assignments, and completed the project?

2. *Partial Condemnation.* Some government agency might decide to acquire only some part of the property for a public purpose—a roadway, parking, a site for a statue of the Mayor. The government must pay fair market value. Some of that money goes to the landlord and perhaps some to the tenant. Each party's lender has first claim to whatever its borrower receives. The lease should define who gets what. That formula must make sense given the deal economics and risk allocations. How often has a government agency partially condemned a ground-leased property?

3. *Prior Mortgage.* If the landlord had a mortgage on its property before signing the ground lease and the parties didn't do anything about the mortgage, then a foreclosure could terminate the lease—destroying the tenant's investment and the lender's collateral. Has this disaster ever occurred?

4. *Subtenant Recognition.* Any tenant under a ground lease will typically sign leases with space tenants, who actually occupy and conduct business in their leased premises. These are legally subleases. If the ground lease terminates, then so do the subleases. Subtenants hate that idea, so they often insist that the landlord agree to recognize them as direct tenants if the ground lease ever terminates. How many times has a ground lease terminated and activated the recognition rights of subtenants?

5. *Extended Nonmonetary Cure Periods.* If the tenant doesn't do something the lease requires, the lease gives the lender a long time to try to fix the problem. If that requires getting into the building, the lease gives the lender time to foreclose or to have a receiver appointed to fix the problem. How often do lenders actually need and use these "extended nonmonetary cure periods"?

6. *Replacement Lease.* If the tenant defaults under the lease and no one—neither tenant nor lender nor anyone else—fixes the problem, then the landlord might terminate the lease. The lender can then obtain from the landlord a replacement lease, on the same terms, so the lender can preserve and revive its collateral. How many landlords have actually given replacement leases to tenants' lenders?

In response to those six questions, my 300 real estate lawyers—who have collectively seen everything, one would think—had no examples of any circumstance where any of the above hypothetical eventualities actually arose in the real world. Although these things could conceivably happen, they rarely if ever do.

Does that mean we should save a few pages in ground leases by deleting language on these hypothetical eventualities? Definitely not! If that language isn't there, a future lender or purchaser will usually flag an issue and have a concern. Even if one of these events is highly unlikely to happen, the market wants to see the ground lease deal with it in an appropriate way.

Because these events are so unlikely to become relevant, any ground lease should deal with each as briefly and simply as possible, doing the minimum necessary to prevent a future issue, rather than trying to achieve perfection. Rather than spending firepower and brainpower to parse through every possible nuance of how these provisions might work, we should make sure they are just adequate. We should save most of our firepower and brainpower for things that actually happen. In the case of the very first item listed above, though, if the ground lease were silent and the tenant didn't assign its contracts, life would go on just fine.

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