

Anticipating Flexibility in Retail Ground Leases

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Retailers have long used ground leases as one of several vehicles to obtain sites for their stores and facilities. In light of the changes that occur as a matter of course in the retail economy, it is essential that the retail ground tenant preserve its ability to react. Recent experience makes it clear that retail executives must be free to make the business decision that is dictated by the economic and business climate in which they exist without being constrained by a patch-quilt of conflicting legal requirements that may be found in the various documents to which a business unit may be subject. As a result, certain issues must be addressed in a retail ground lease.

Assignability

The ground lease must be freely assignable without any controls being placed by the landlord on the retail tenant. Economically, the ground lessor is typically in the most secure position, unless it has encumbered the property for the benefit of its ground tenant.

The landlord will typically want the ground tenant to remain liable for the tenant's obligations under the lease, notwithstanding the assignment. Unfortunately, due to the term length of a typical retail ground lease, this contingent liability may last for quite some time and burden the retailer's balance sheet. To avoid this result, the assignment of the ground lessee's interest to a creditworthy assignee should relieve the ground lessee of its obligations. Alternatively, the ground lease will provide that the assignor shall only be liable for the obligations of the tenant under the lease until the end of the current term, and specifically exclude liabilities arising during option terms that were not exercised by the assigning ground tenant.

The ground lease should not provide that an assignee is required to execute an assumption agreement or otherwise be obligated for ground lease obligations that predate or postdate the tenure of a holder of the ground lessee's interest. Without the requirement for the assignee's assumption of the tenant's obligations under the ground lease, privity of estate will make each subsequent holder of the ground lessee's interest liable for the tenant's obligations, but only those obligations that arise during the tenure of such holder.

If a written assumption agreement is required, it should provide for the assumption of obligations arising during the time that a subsequent holder of the ground lease interest retains its interest, and expressly negate pre- and post-tenure obligations.

In this way, any assignee of the ground lease will be obligated only for its performance of lessee obligations arising during the time that it holds its interest. Of course, the assignment would not relieve a prior holder of its preassignment obligations for which it would remain liable.

Estoppel Certificates

To protect against the enforcement of remedies by the ground lessor for breaches by a prior holder of the ground lessee's interest, the ground lease should obligate the ground lessor to give an estoppel certificate to an assignee or subtenant. This provision should specifically require that the estoppel certificate identify the ground lease and any amendments and modifications, state the amount of ground rentals then being paid by the ground lessee, state the amount of any other sums that are being paid by the ground lessee to the ground lessor, state the date through which all sums payable by the ground lessee to the ground lessor have been paid, and state that the ground lessee and ground lessor are not in default in their obligations under the ground lease, or describe any default, if one should exist.

Renewals

Landlords have, from time to time, limited renewal rights to the original tenant. This is especially the case where the lease contains provisions that reflect special concessions that have been made to anchor tenants in an effort to cause the space tenants to follow. A tension is thus created between the desire of the prime retailer for these concessions and the unwillingness of the Landlord to extend those concessions to an assignee of a prime retailer. One way that is typically used to deal with this issue is to provide that renewal options may not be exercised by an assignee. While these provisions may find a home in the retail space lease, they should not be found in the ground lease. Since economically the ground lease is more of a financing vehicle than a true lease, the ground lessor should be satisfied with a secure return on its land value, rather than trying to terminate the relationship early.

Renewal options become very important in the assignment of a ground lease. The assignment typically involves not only the passage of the lessee's right to possess the land, but also the sale of the improvements that have been constructed by the assigning ground tenant. As a result, the assignee will have a significant investment in the physical facility built upon the leased land, in addition to the investment that the assignee makes in developing the market for the location. The assignee will rightfully insist upon the ability to exercise all of the renewal and extension options that are otherwise available to the original tenant.

Lender Provisions

While the original ground tenant may be financially strong and proceed without the need for leasehold financing, its business practices may change. Its financial decision makers may raise capital in various ways, whether through lease/lease-back transactions, portfolio transactions, or simple ground lease mortgages. As a result, the ground lease should contain protections that a lender will require, if the ground lease is to be financed. These protections will specifically allow the encumbrance of the ground lessee's interest without the ground lessor's consent

or approval, and provide for non-disturbance and attornment running for the benefit of a foreclosing lender and a purchaser at a foreclosure sale.

Additionally, the ground lease should specifically provide that any notice of default by the tenant shall be given not only to the tenant, but also to any tenant's lender of which the ground lessor has notice. The tenant's lender should be expressly granted the right to cure defaults by the ground lessee, with ample cure time allowed to the leasehold lender. If the ground lessee's default is non-monetary, the leasehold mortgagee must be given adequate time to enforce its rights under the loan documents, obtain possession of the premises, and then cure the default under the ground lease. In exchange, the leasehold lender should be obligated to not allow, or to cure immediately, any monetary defaults, so that the ground lease payments continue to be made while the lender is attempting to cure a nonmonetary default, or gain possession of the premises to effect such cure.

The ground lease should also prohibit the surrender, termination or modification of the ground lease without the written consent of a leasehold mortgagee of which the ground lessor has notice. Without such protection, the estate that constitutes the security for the leasehold mortgage may disappear. Similarly, ipso facto bankruptcy and other non-cureable default clauses should be eliminated from the ground lease. Such clauses would have the effect of allowing the ground lease to be terminated without giving the leasehold lender the opportunity of preventing such a result by curing the default.

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Insurance Proceeds and Condemnation Awards

The ground lease may require that any condemnation awards be paid over to the ground lessee. If that is the case, the tenant should at least obtain protection for the use of such awards to the extent that they compensate for the taking of improvements made to the property by the ground tenant. This benefit is especially important for the original tenant who has constructed the improvements and an assignee who may pay a significant amount for the improvements constructed by the original ground tenant.

Similar issues arise with respect to insurance proceeds. If the property is damaged by casualty, the ground tenant may insist upon the right to use the insurance proceeds for any purpose whatsoever, including simply taking those proceeds without rebuilding the structure. The landlord will want the ground tenant to be obligated to rebuild. While the ground lessor may have an expectation of receiving the improvements at the expiration of the term, such is not always the case. Especially where the tenant obtains or pays for the casualty insurance coverage, retailers often successfully negotiate for the right to utilize insurance proceeds to repay themselves for the cost of the improvements and expressly negate any expectation that the property is to be surrendered to the ground lessor with the improvements intact.

As can be seen, ground leases in a retail context present some interesting challenges and negotiating issues as the retailers strive to maintain their flexibility while landlords strive to maintain their position as landholder with a present cash flow and a substantial, if deferred, remainder interest in the property.