

COMMITTEE ON REAL PROPERTY LAW  
NEW YORK CITY BAR ASSOCIATION

COMMENTARY ON FORM OF GROUND LEASE (2009)

Ground leases often involve the lease of an entire parcel of land by a developer who intends to construct a building on the land. The cost of the construction will generally exceed by many multiples the value of the land. Accordingly, the tenant will need a very long term lease to recover its investment and will want, essentially, to be treated as the owner of the property. For that reason ground leases differ in a number of basic respects from office and retail leases.

Among other things:

The tenant generally asks for, and receives, the right to mortgage and assign the lease without landlord consent (although assignment rights may be prohibited until the facility is constructed), and the right to sublease without consent.

If the tenant defaults and the tenant or its lender has inadequate cure rights, the entire investment is lost. For this reason default clauses in ground leases generally give the tenant considerably greater cure rights than office leases.

From the lender's standpoint, a ground lease that can be terminated through default or bankruptcy, is no collateral at all. Accordingly, the lender will want the right to a new lease if the lease is terminated by reason of the tenant's default or is rejected in bankruptcy.

The tenant will bear all the expenses of owning and operating the property, except for the landlord's personal expenses, such as income tax liability.

The Committee on Real Property Law, in furtherance of its mission to provide forms for use by general real estate practitioners, has drafted a form of ground lease for vacant land. The committee's goal was to create a landlord-friendly form that a tenant would find, in general, reasonably acceptable. Decisions were made as to how to handle various issues, and some of the judgments that went into the decisions are outlined in this commentary.

Because the ground lease is intended for use with a vacant parcel of land, it must be modified if the ground lease involves an existing building. The commentary indicates

some (but not necessarily all) of the provisions that must be modified for a lease of an existing building.

Anyone using the form of ground lease should recognize that (a) it is a form, and as such, must be tailored to the individual transaction, and (b) it is not an infallible document, and (c) it is, as are all leases, subject to interpretation, and (d) this form was published in 2009 and so may become outdated over time. Using his or her professional judgment, the user should carefully review the form before using it, and make the appropriate modifications.

One issue the parties should consider before commencing negotiations is confidentiality. If the landlord is delivering environmental reports or other documentation considered confidential to the tenant, the tenant should be asked to execute an appropriate confidentiality agreement. Conversely, if the tenant obligates itself to deliver materials it would normally consider confidential to the landlord during the term of the lease, it should consider including a confidentiality provision in the lease. Both parties, in drafting and negotiating confidentiality provisions, should avoid overbroad provisions that cover non-critical information or that are likely to be violated over a long term lease.

#### ARTICLE I. BASIC TERMS AND DEFINITIONS; RULES OF CONSTRUCTION.

Article I first sets out the business terms, such as the description of the land, definition of “Improvements” and “Premises,” the base rent, the commencement date, and the identity of the guarantor.

Note that the “Permitted Use” of the property is broad. Section 1.01(m) permits any legal use. Most ground leases give the tenant considerable flexibility in the use of the premises. However, if the landlord expects the tenant to build and operate a particular kind of facility (such as a residential apartment building or a commercial office building), the landlord may want to draft a more restrictive use clause. Section 2.05 is the lease provision that specifically prohibits designated uses, such as the sale of pornographic material, and can be expanded to cover other undesirable uses.

Section 1.02 includes general definitions, such as for “Additional Rent” and “Affiliate.” As with most leases, the word “including” always means “including but not limited to”; and the Committee means exactly that. Courts should not attempt to restrict the operation of substantive provisions of the lease by ignoring defined meanings.

1.02(h) defines “Institutional Lender.” The term is important because the landlord’s consent is not required for any leasehold mortgage given an Institutional Lender. Section 1.02(h) includes a net worth test and an asset test. The numbers have to be filled in. If the property is located in a suburban or rural area dominated by local banks, the net worth test will be very different.

1.01(k) defines “Market Value.” The definition used is the definition found in federal regulations. 12 C.F.R. Part 34.42(g); 55 Federal Register 34696, August 24, 1990, as amended at 57 Federal Register 12202, April 9, 1992; 59 Federal Register 29499, June 7, 1994. The Committee elected not to include a provision calling for the redefining of “Market Value” to reflect current regulations or current appraisal practice at the time of appraisal (we note that there are many different definitions used in appraisal practice) because it was felt that the current definition is a good one and that the parties should be able to rely on the definition in place at the time the lease is signed, without injecting uncertainty into the process by calling for a floating definition.

## ARTICLE II. LEASE OF PROPERTY; “AS IS” CONDITION; COMMENCEMENT DATE AGREEMENT; TERM OF LEASE; PERMITTED USE

Section 2.01 contains the basic demising language. Many ground leases list all encumbrances on the property in this clause, stating that the premises are leased to the tenant “subject to the following” and then listing the encumbrances. The committee felt that the tenant should rely on its title report, and that it was inappropriate to include any representation by landlord as to the state of title to the premises. If the landlord gives such a representation, it should be limited to the state of title at the time of execution of the lease.

The entire “Premises,” including development rights, are leased to the tenant. Accordingly, if the landlord wants to retain the right to sell development rights, it should reserve such right in the lease.

As is usual, Tenant accepts possession of the premises in its “as is” condition on the commencement date, which is appropriate for vacant land. Section 2.02. If the ground leased property is improved by a building and the commencement date will occur some time after the date the lease is executed, the tenant may want to modify the provision by providing that the premises will be in their “as is” condition as of the date of execution and delivery of the lease, subject only to reasonable wear and tear. The issue for both landlord and tenant is who takes the risk of damage to the property occurring between the date the lease is signed and the commencement date. If there is a building on the property and there is a delay between the execution of the lease and the commencement date, the parties should also consider the effect of a casualty or condemnation during that interim period.

Section 2.04 assumes that Landlord is delivering vacant land or an empty building to the Tenant and so provides that the tenant will be given vacant possession. If the ground lease is for an existing, tenanted building or if the tenant is acquiring the property subject to any leases, this provision must be modified. For a tenanted building, the landlord will be required to assign to tenant, and tenant to assume, all existing leases, licenses, and other occupancy agreements, the security deposits will be transferred to the ground lease tenant, and, if there is an interim period between the execution of the ground lease and the commencement date, the landlord generally will be barred from signing any new lease or occupancy agreement without tenant’s consent.

Section 2.05 prohibits some uses of the property. Landlords generally prefer not to lease their properties to foreign governmental entities or to the United Nations, or any of their arms, because of (a) sovereign immunity issues and (b) the possibility of picketing and bomb threats resulting from the presence of a foreign entity or the United Nations. Sovereign immunity can largely be waived, although some entities (such as the United Nations) may refuse to waive immunity. Domestic governmental entities may also raise issues for landlords because some government departments service the public (e.g., the motor vehicle agency) and may create traffic and other problems within the building.

### ARTICLE III. RENT.

Section 3.06, as is customary, provides that this is a net lease, and that the tenant will pay, among other things, the expenses of operating and maintaining the property. The intent is that the landlord take home the agreed fixed rent, without deduction for any expense of operating or maintaining the property. Because the assumption is that the property is vacant, the lease does not take into account treatment of service contracts, management agreements, etc.

Article III also provides for both payment of a late fee and interest on overdue payments. Generally, the amount of late fees are to some degree negotiable. Generally, a tenant will not want to pay both late fees and interest. However, the landlord should insist on a late fee to encourage timely payment of rent, and needs the right to interest in the event it is caught up in a lengthy litigation during which the tenant pays no rent.

### ARTICLE IV. IMPOSITIONS

The tenant pays all “Impositions.” That is, all real estate taxes, water and sewer rents, Business Improvement District charges (in New York City), special assessments, and other governmental charges relating to the property and the equipment and personal property used in the operation of the property. The term “Impositions” does not include mortgage tax on fee mortgages placed on the premises by the landlord (unless the fee mortgage is granted to the tenant’s leasehold lender at the request of the tenant); and it does not include transfer taxes imposed on the landlord, since the tenant should not have to pay transfer taxes imposed on the owner for the sale of the property. However, transfer taxes payable in connection with the lease are covered by Article XXVI.

Impositions are apportioned between the parties at the beginning and end of the lease term. Section 4.03 and 4.04.

Certiorari proceedings are covered by Section 4.07 – 4.09. The basic idea is that the landlord will continue to prosecute proceedings that are already pending, and thereafter the tenant has the first right to initiate such proceedings. If the tenant does not choose to initiate certiorari proceedings, it must notify the landlord before the deadline for filing has passed, in order to allow the landlord to file. Refunds and tax credits

resulting from the proceedings are paid to the party who paid the tax for which the refund or credit is awarded.

#### ARTICLE V. INITIAL CONSTRUCTION.

Article V sets out the requirements for the initial construction of the facility. Generally, the tenant is required to build a facility that meets specified criteria (e.g., a modern, fully air conditioned office building, with a minimum rentable square footage of \_\_\_\_\_; at least \_\_\_ floors, with a minimum floor to ceiling height of \_\_\_\_\_). The criteria may be relatively simple or more detailed. They should, at a minimum, establish the type of building to be constructed, its minimum square footage, its minimum height, the quality of construction, and, possibly, the level of completion (e.g., installation of finished walls and floors). The parties may want to specify the quality of the construction by referring to other existing buildings.

In New York City, it is not unusual for builder-owners to acquire development rights owned by adjacent property owners in order to increase the size of the building that can be constructed. Accordingly, a New York City ground lease tenant needs to consider including a provision in the ground lease obligating the landlord to cooperate with tenant's efforts to obtain the development rights of others, including by execution of a zoning lot development agreement and merger of the premises and an adjacent parcel into a single zoning lot. The landlord, of course, may want a right of reasonable consent to the form and substance of the agreements.

The landlord will want some form of security from the tenant to ensure that construction is completed, because a failure to complete construction can cost the landlord a very substantial amount of money in the form of mechanics liens, demolition cost, and/or construction costs. The ground lease form provides for security in the form of a completion guaranty or a letter of credit in an amount equal to 125% of the estimated construction cost. Such a letter of credit may, depending on the construction cost, be prohibitively expensive. In addition, the landlord will generally have difficulty obtaining a letter of credit from a major developer or credit tenant, such as a Lowe's or Home Depot. If the landlord is unable to obtain a letter of credit or other independent security from the tenant, it should at least, if the tenant is a shell entity, (a) have the "credit" parent company sign the lease, with the right to assign the lease to the tenant and be released from liability once construction is completed (except for accrued obligations), or (b) obtain a guaranty from the credit entity. The landlord should bear in mind that there must be consideration for a guaranty. If the guarantor is a parent or principal of the tenant, there is usually no problem. If, on the other hand, the tenant is the parent or principal of the guarantor, landlord should ensure that there is other binding consideration, since "upstream" guaranties are problematic from an enforcement perspective.

The model form of ground lease includes a full guaranty of the lease, which ends once the "Construction Completion Date" has occurred and the space tenants are paying, and tenant is collecting, a minimum amount of rental. Exhibit 10. The tenant may seek

to negotiate a more limited form of guaranty – e.g., one that guaranties only completion of construction and prompt discharge of any mechanics liens. The guaranty is usually heavily negotiated. The tenant will not want to guaranty completion of fit outs for space tenants, and will be concerned about guarantying “timely” completion of the facility. The landlord should bear in mind that it may be time consuming and difficult to prove its damages for the tenant’s failure to timely complete the facility and/or space tenant fitouts.

Completion bonds (in which a surety agrees to complete the construction) are difficult to obtain and even more difficult to enforce. Accordingly, the lease does not specifically require bonding of the work. Payment and performance bonds do not protect the landlord from the tenant’s failure to pay the contractor, which is generally the landlord’s major risk. They only purport to protect against the contractor’s failure to perform and pay its subcontractors if the contractor has been paid. Of course, if the landlord has concern about the quality of the contractors the tenant may engage, it may want to include a requirement for performance and payment bonds.

Another way to handle construction security is to have the tenant post cash as security, and to reduce the cash security as the construction progresses. Any such provision should be drafted in consultation with an architect, in order to determine how much the cash security should be reduced each time the tenant reaches a specified milestone in the construction. If the construction security is a letter of credit, the tenant may similarly want the ability to reduce the letter of credit each time the tenant meets a construction milestone.

To protect itself if there is a significant change in the market or unforeseen conditions that make construction of the originally contemplated facility impracticable, the tenant may negotiate for the right to surrender the premises to the landlord and terminate the lease (with its lender’s consent) provided it restores the property to its original condition (demolishing all improvements and grading the land to make it reasonably level) and pays the landlord a negotiated termination fee. Naturally, any such right would have to be exercised by some agreed date or prior to substantial completion of the construction.

Tenant may not commence its initial construction until it has met certain conditions. Section 5.03. One of the conditions is that the tenant has obtained a financing commitment for the initial construction and that the commitment be in full force and effect. The landlord may want to tighten up that requirement to require the tenant to have closed on the loan. But if it is critical for the tenant to start construction even before the loan is funded, the landlord may be unable to successfully demand this condition. On the other hand, if the landlord has concerns about the tenant’s ability to fund the construction, the landlord should not permit the tenant to start construction until the loan has closed.

The Committee elected to give the landlord the right to approve the tenant’s initial construction, such approval not to be unreasonably withheld or delayed. Section 5.02. Because construction delays can cost a great deal of money, the section provides that the landlord is deemed to have approved the tenant’s plans if the landlord fails to approve or

disapprove within 30 calendar days for the initial set of plans and within 7 calendar days for material modifications to the plans. This section ties in with Section 5.04 (tenant's timetable), in that the time periods set out in the timetable are extended to reflect actual delays caused by landlord's failure to approve or disapprove within such 30/7 day period. The tenant may also negotiate for an extension in the rent commencement date to the extent the tenant's construction is actually delayed by landlord's failure to timely act.

If the land's value is negligible compared to the value of the improvements, the tenant will generally oppose giving the landlord any approval rights as to the initial construction. Construction approval rights are often a major bone of contention in a ground lease. If the landlord is not given any approval rights, the timetable (Section 5.03) must be modified to eliminate the sentence extending the time periods for delays caused by landlord's failure to grant or deny approval within the required time periods.

The Committee also elected to include a timetable setting out the dates by which the tenant must, among other things, deliver to landlord complete plans and specifications, determine the estimated cost, obtain construction financing and permanent financing (attorneys should note that permanent financing may not always be available at the time the construction loan commitment is obtained), have met the construction commencement conditions, and substantially complete the initial construction. Tenants will generally oppose inclusion of any timetable and, if a timetable is included, negotiate very generous time periods, together with a *force majeure* extension.

Tenant is given 30 days after it receives notice of filing to discharge mechanics liens. Section 6.13; 20.01. The 30 day time period set out for discharge of mechanics liens should be adjusted to reflect the time required in the jurisdiction in which the property is located, to bond and discharge a mechanics lien. In addition, with respect to Section 20.01, the tenant may want to consider negotiating for a suspension of its obligation to bond and discharge a mechanic's lien filed by reason of work performed for a subtenant or request a more extended cure period, in order to give itself time to enforce its rights against the subtenant to bond the lien.

## ARTICLE VI (ALTERATIONS)

The model form includes a general alterations clause that covers the initial construction and subsequent alterations. Landlord consent is required for specified kinds of major construction, such as demolition of all or part of the building. There is normally a negotiation over what kinds of alterations require the landlord's consent and whether the landlord must act reasonably.

The tenant should review the alterations clause (as well as all other clauses) carefully for traps. For example, a conditional requirement that must be met before commencement of construction is arguably a default that, once breached, cannot be cured after construction has started. For the tenant, affirmative requirements (tenant shall obtain all required permits) are better than conditions (tenant cannot commence construction prior to issuance of commitments).

In addition, the tenant may find Section 6.06's insurance requirements overbroad (for example, builder's risk insurance is not appropriate for all construction projects).

Section 6.06 requires the tenant to maintain during the course of the construction, owner's contingent or protective liability insurance. Because of its cost, such insurance is usually obtained only for major construction projects (costing at least \$5,000,000.00 or \$10,000,000.00). The contractor usually purchases the coverage on behalf of the Owner, including the cost in the contract price.

With respect to Section 6.06, the parties should note that coverage against bioterrorism and nuclear accident is not currently available under today's general property damage policies. Builder's Risk insurance generally comes into play only when the owner or tenant is changing the structure of the building (e.g., demolishing 3 floors to build an atrium), not when the tenant is simply altering the building (e.g., by pointing the building's exterior walls). Landlords will generally require Builder's Risk insurance in the following three situations: (1) the tenant is constructing a building, (2) the tenant is engaged in major construction affecting the basic structure of the building, and (3) the tenant is adding to the building. The tenant's property damage policy, if the agreed amount coverage is appropriate, will usually cover damage to ordinary alterations. Builder's risk coverage, when obtained, should include an "installation floater," which covers damage to materials and other property before installation. It is particularly appropriate to obtain for custom work (such as a specially manufactured marble elevator cab). Builder's risk insurance should be written on a completed value basis (non-reporting full coverage), which simply means that it will cover all work that's been performed to date without the need to periodically report what portion of the construction has been completed and the value of the completed portion.

Section 6.06 mandates wrap up insurance if the estimated cost of construction exceeds an amount to be specified by the parties. Wrap up insurance is a single liability policy carried by the tenant that covers the acts and omissions of all construction managers, general contractors, and subcontractors. If wrap up insurance is obtained, the construction managers, general contractors, and subcontractors are not required to carry their own policies; instead, they are "wrapped up" in the tenant's policy. As of the date of this Commentary, because of their cost, wrap up policies are generally used only where the cost of the construction exceeds \$50,000,000.00. Such policies generally include a substantial deductible (of approximately \$500,000.00). Wrap up insurance should only be used, and may only be available, if the subcontractors working on the project are strong enough financially to handle such high deductibles. The tenant may have to pay over a portion of the insurance savings resulting from use of a wrap up policy to the general contractor, who will need the additional money to fund the additional effort required to qualify the project as a "safe workplace site" for wrap up coverage. The owner and tenant should ensure that the contractor does not hire the "C" team of contractors to save money when wrap up insurance is obtained. The issue for the tenant is whether it should be forced to obtain such a policy, or whether the policy should be an option the tenant may turn to in lieu of requiring its contractors and subcontractors to

obtain their own insurance. The tenant should also consider the possibility that wrap up insurance (or any other insurance required by the ground lease) will not always be available during the 50 or 100 year term of the lease.

The tenant's attorney should, at the inception of the ground lease negotiation, establish a working relationship with the tenant's insurance consultant and review the ground lease requirements for insurance, including both construction insurance and Article IX's general insurance requirements, to assure itself that the lease does not impose requirements that the tenant may not be able to meet over the term of the ground lease, does not require the tenant to obtain coverage that is not customary, and does not include requirements that are onerous or inappropriate.

The other requirements of the alterations clause should be reviewed by the tenant's attorney for possible traps. For example, the requirement that tenant replace any fixtures, machinery, and equipment removed from the premises may be unrealistic over the term of a 100 year lease. Technology may change, causing the abandonment of equipment or systems for other equipment or systems. From the tenant's perspective, it should only be subject to a requirement that it not commit "waste" or create a nuisance.

The tenant may also negotiate for landlord contribution to the cost of major capital improvements made by the tenant at the end of the lease – on the theory that the landlord will benefit from the improvements more than the tenant. Such improvements might be necessitated by changes in law or by ordinary wear and tear. Although the tenant's argument has a rational basis if the improvements are necessitated by the enactment of a new law, the argument has considerably less force if the improvements are required by reason of natural deterioration (since a prudent tenant should maintain sufficient capital reserves to cover needed improvements). Few landlords would be willing to commit to make such a contribution. If the landlord is unwilling to make such a commitment, the tenant may argue that it should be excused from any obligation to make such improvements. The issue highlights the dilemma of the landlord at the end of the ground lease term. Ground lease tenants tend to lose interest in investing in the property as the lease term approaches its end. Accordingly, the landlord may find, at the end of 100 years, that the building is an out-of-date, deteriorated albatross that will require a very substantial investment to make marketable.

#### ARTICLE VII (COMPLIANCE WITH LAWS; ENVIRONMENTAL).

Article VII basically places on the Tenant full responsibility for compliance with all laws, including environmental laws. The tenant may negotiate to carve out (a) compliance responsibilities relating to violations of law as to which a notice of violation is outstanding as of the Commencement Date, or (b) compliance responsibilities relating to conditions existing as of the Commencement Date. Clause (a) is simply a matter of negotiating leverage. Adoption of clause (b) potentially opens up a can of worms for the landlord because it is often difficult to establish when a condition arose. Accordingly, the inclusion of such a limitation could embroil the landlord in one or more disputes with the tenant as to who should bear the cost of remediation. If the landlord has sufficient

leverage, it generally will tell the tenant to rely on its own environmental and property condition report, and will refuse to assume responsibility for pre-existing conditions. That said, it would not be unusual for the tenant to request, and the landlord to give, a representation that the landlord has no actual knowledge of any release of hazardous materials onto or from the premises.

Section 7.03 gives the tenant the right to contest violations, fines, penalties, the application of a particular law to the premises and similar matters; but not mechanics liens, which are dealt with in Sections 6.13 and 20.03. The tenant is permitted to contest violations only if the conditions specified in Section 7.03 are met. The landlord should recognize that if the tenant is contesting a violation, penalty or other matter, the landlord may be unable to finance or refinance its fee estate. The committee elected not to prohibit the tenant from contesting if such contest would preclude the landlord from financing or refinancing its fee interest, because the landlord's right to encumber its fee is, as a general principle, subordinate to the ground lease and leasehold mortgage. However, in a particular transaction, it may be appropriate to include such a prohibition in the lease.

#### ARTICLE IX (INSURANCE).

Article IX requires the tenant to carry, among other things, liability insurance (including fire and legal liability coverage), property insurance, workers compensation, and automobile insurance.

The article specifies the kind of insurance must be carried at the inception of the lease, but is structured to allow the landlord to increase or modify the required coverage. The clause is structured in this way because ground leases are long term agreements, and insurance that is customary and available today may not be customary or available 30 years later. New forms of policies may be written, and today's standard policy limits may become tomorrow's underinsurance. Anyone using this form of ground lease should have it reviewed by an insurance consultant to make sure that the specified coverages are appropriate.

The landlord will be named as additional insured on the tenant's liability policy. Landlords should note, however, that although, as additional insured, it is entitled to a defense by the tenant's insurer if the claim arises in connection with a claim that the tenant was negligent, the tenant's insurance company will not cover loss caused by the landlord's own negligence. Accordingly, it is prudent for the landlord to maintain its own liability policy. Alternatively, the landlord could require the tenant's insurance company to add the landlord as a named insured.

Landlord and any fee mortgagee is entitled to be named as loss payee under the tenant's property damage (fire) and boiler policies, but only if the lease is not encumbered by a leasehold mortgage.

The liability coverage must include fire and legal liability coverage, which covers the insured against claims by third parties for damage caused by fire. Fire and legal liability usually carries a low limit of coverage (e.g. \$100,000.00) that is expanded through umbrella coverage.

The ground lease also requires the tenant to carry automobile insurance. Tenants that don't own cars or trucks (usually tenants located in cities) may question the need for such insurance. The drafters nevertheless believe that it is a good idea to require such insurance because (a) it is prudent for the tenant to carry such coverage, and (b) if the tenant obtains an umbrella liability policy, as is common, automobile insurance is usually automatically included in the umbrella coverage.

The form lease requires the tenant to carry a property policy that does not exclude coverage for mold, terrorism and other matters. Although terrorism coverage is currently available (as of 1/2008) because the federal government subsidizes losses from foreign and domestic terrorism under the Terrorism Risk Insurance Act ("TRIA"), it is possible such coverage will someday become unavailable. Accordingly, the tenant may want to be excused from its obligation to cover terrorism, or to carry any insurance that is not available at commercially reasonable rates, if such coverage is not then being required by institutional lenders with respect to comparable properties. If the landlord accepts such a limitation, it would want to be sure that the tenant carried at least the maximum insurance "customarily" required, and it would ask the tenant to resume carrying the omitted coverage if such insurance subsequently became available.

Basic property policies do not usually cover mold and fungus. Accordingly, the tenant would need to obtain a special pollution policy, which is usually obtained only for entire buildings, to provide such coverage. Tenants and landlords should note that insurance companies are now coming out with special package programs for "green" buildings.

Property insurance policies typically include a co-insurance provision that basically provides that if the property is insured for less than 80% of its actual replacement cost, the insured's recovery after a casualty will be concomitantly reduced. Accordingly, if a building's actual replacement value is \$1,000,000, the building is insured only for \$500,000, and a \$100,000 loss occurs, the insured will recover only \$50,000 from the insurance company. In part to avoid the effect of the co-insurance provision, property insurance is required to be carried in an amount equal to the "agreed replacement value," which is a figure determined by the insurance company in consultation with the insured. Having agreed to the replacement value, the insurance company may not invoke the co-insurance provision if the property is underinsured. That said, it is not unusual for the "agreed replacement value" to be significantly less than actual replacement value. To guard against underinsurance, the landlord may want to have the right to object to the tenant's determination of the agreed replacement value, based on the opinion of an appraiser, general contractor, cost estimator, or independent insurance adjuster engaged by landlord. If there is then a dispute, a procedure must be incorporated in the lease for resolution of the dispute (for instance, through appointment

of an independent appraiser). If the landlord includes such a clause, the tenant will want to limit the frequency of such reappraisals. The Committee did not include such a clause because (a) the leasehold mortgagee will generally police the tenant's insurance coverage, and (b) such a provision is not customary.

With respect to workers' compensation and employer liability coverage, tenants should note that some states pay such claims out of a state insurance fund, to which each employer pays a premium. In such states, the tenant should investigate the solvency of the state's fund and its capacity to respond to significant claims. In some states, such coverage can be obtained from private insurance funds. If the tenant's workers' compensation and employer liability coverage fail, the landlord's exposure to loss is generally very remote.

Section 9.02 limits the amount of the tenant's deductible under its policies to an agreed amount (which must be specified in the lease). The amount of the deductible that is appropriate will depend on the type of tenancy (e.g., retail or office) and the financial strength of the tenant. In New York City currently, deductibles are usually set at under \$25,000.00.

Section 9.03 requires the tenant's insurer to have a claims paying ability rating of no less than "A-8" and a financial class category rating of at least "VIII" by A.M. Best Company. The tenant should note that although this standard may be appropriate for New York City, it may not be appropriate for other areas. In addition, such highly rated companies may not provide insurance in certain areas of the country (for example, it would be very difficult to obtain coverage from an A-8 company in an earthquake or flood area).

The tenant is required to deliver to landlord binding certificates of insurance evidencing the required insurance; and, upon request and at landlord's option, copies of the policies or the Declarations pages. The certificate is often useless as evidence of insurance coverage. Accordingly, the landlord should always confirm that the required policies and coverages have, in fact, been issued by inspecting either the policies themselves or the declarations pages to such policies coupled with the policy list of endorsements and exclusions. "Credit" tenants (the General Electrics and big box tenants of the world) will often refuse to give their landlords copies of the policies.

Section 9.07 does not include a release and waiver clause under which Landlord and Tenant each agrees that, to the extent it is insured or required to be insured, it will not make any claim against the other party for casualty damage caused by the other party. The clause is omitted on the assumption that the tenant has built the building and is responsible under the lease's casualty provisions for rebuilding after a casualty, and on the assumption that the landlord has no role in operating the property. If the tenant is ground leasing an existing building (which exposes the landlord to liability), or if the landlord is involved in the management of the property, a release and waiver clause should be included. Section 9.07 does require the tenant's insurance to include a waiver of its subrogation rights in favor of the landlord.

Section 9.07 also requires the tenant's policies to be primary and not contributing to or in excess of any policies carried by Landlord. This language is intended to assure that the tenant obtains a policy that steps up and defends the owner if a claim is made, so that the owner does not have to resort to its own policy for defense in the first instance. However, even if the tenant's policy is primary, the owner will usually still maintain its own contingent liability policy.

Although Article IX does not attempt to specify the insurance that the contractors of the tenant's subtenants must carry, it does obligate the tenant to require such contractors to name the "Landlord Parties" as additional insured and to include waiver of subrogation in favor of the Landlord Parties, *to the extent* that the tenant requires the contractors to provide such protection to the tenant. Tenants should bear in mind that it may not always be practical for contractors and subcontractors to obtain such waivers. Owners should bear in mind that because they have potential liability for certain worker injuries under New York's "Scaffolding Law" (NY Labor Law §241), it is important for the owner to be named as additional insureds on the contractors' and subcontractors' liability policies.

Article IX also requires the tenant to require its subtenants to carry "Customary" insurance coverage, to name the Landlord Parties as additional insureds, and to obtain waiver of subrogation endorsements on all policies in favor of the Landlord Parties; and also to require its managing agent to carry fidelity insurance (which is usually in an amount equal to 3 months' rent from all tenants). Some tenants may regard these requirements as overly intrusive, and seek to eliminate any possible oversight of its insurance requirements with respect to its subtenants and managing agents.

#### ARTICLE X. INDEMNITY.

Article X basically requires the tenant to indemnify the landlord against anything that happens on or about the property, unless the loss is caused by the landlord's negligence. The breadth of the indemnity stems from the situation – the landlord is turning over the entire property to tenant for an extended period of time and expects the tenant to have the same responsibility it would have if it owned the property.

#### ARTICLE XI. DAMAGE AND DESTRUCTION.

Tenant bears all risk of loss due to fire *or any other cause*. Accordingly, if the premises are damaged by fire, terrorism, or other cause, the tenant must still perform all of its obligation under the lease – with one exception. If the damage occurs during the last 5 years of the lease, the cost to restore exceeds 50% of the full replacement cost of the building, *and* the loss is covered by insurance, the tenant may terminate the lease provided the applicable conditions are met. If tenant so terminates, the lease is not terminated, until the full amount of the insurance is paid, and rent must be paid until termination. Because it may take years for insurance proceeds to be fully adjusted and paid out, Tenant may negotiate for a termination that becomes effective once the

conditions set out in Section 11.03(a)-(h) are met, provided the insurance policy is valid and subsisting without any defenses to the payment thereof by the insurance carriers based on the acts or omissions of tenant or any subtenant.

If the tenant does not terminate, the insurance proceeds will generally be paid out for restoration in accordance with procedures established in the leasehold mortgage. If there is no leasehold mortgage, the lease provides for the payment of the insurance proceeds to a third party depository if the restoration cost exceeds an agreed amount. The depository must be a commercial bank or trust company selected by Landlord that is subject to supervision and regulation by state or federal governmental authority and that has capital, surplus, and undivided profits of at least \$100,000,000.00. Alternatively, the landlord may want to use a test that keys into agency ratings, such as: A depository institution or trust company insured by the Federal Deposit Insurance Company, the short term unsecured debt obligations or commercial paper of which is rated at least "A-1+" by Standard & Poor's Rating Services, "P-1" by Moody's Investor Services, Inc. and "F-1" by Fitch, Inc. in the case of accounts in which funds are held for 30 days or less (or, in the case of accounts in which the funds are held for more than 30 days, the long term unsecured debt obligations of which are rated at least "AA" by Fitch, Inc. and Standard & Poor's Rating Services and "Aa2" by Moody's Investor Services, Inc.).

## ARTICLE XII. CONDEMNATION.

Condemnations rarely occur, but the provisions allocating the condemnation proceeds are often the subject of heated negotiations. Article XII deals with condemnation and it includes a very pro-landlord clause that recognizes that the value of the landlord's interest in the property may exceed the value of the fee estate itself. This clause will probably not be acceptable to a leasehold lender, who will either want to limit the landlord's share to the value of its fee estate or will want to ensure that its mortgage is fully paid before the landlord participates in any condemnation proceeds payable to landlord that exceed the value of the fee estate.

*Participation in Condemnation Proceeding.* Section 12.02 provides that each party may appear in the condemnation proceeding. The leasehold lender also has the right to participate in the proceedings and settlement discussions and has the right to supervise and control the tenant's award (Sec. 15.18). In the condemnation proceeding itself, the court will generally issue an award based on its determination of the value of the entire premises. It is up to the landlord and tenant to divide the award. The model ground lease does not provide a mechanism for resolution of any disputes concerning the division of the award. If there is a dispute, the condemning authority will not pay the award (in which event the condemning authority will pay interest at the then applicable rate – 9% as of 12/31/07) or will deposit the award into interpleader (in which event the award will bear interest at a much lower rate) until the parties agree to the division of the award or a court decides the dispute. This obviously delays payment of the award. Although the tenant usually is entitled to the lion's share of the award, an obstructive landlord with a relatively small interest in the award can tie up the award for a significant period of time if it refuses to act reasonably. From the tenant's standpoint, this is the tail

wagging the dog. Accordingly, the parties (tenant in particular) might add a provision for payment of the award to a designated depository if there is a dispute, with instructions to deposit the award in a high earnings account, while the parties baseball arbitrate or litigate the allocation of the award. Baseball arbitration has the merit of encouraging the parties to be honest.

*Substantial Takings.* The model form provides that if there is a total or substantial taking, the lease automatically terminates on vesting of title. A “substantial taking” is defined as one in which more than \_\_\_ % of the rentable area of the Improvements is taken (the percentage to be determined by the parties), or more than \_\_\_% of the parking spaces at the premises (if there is a parking lot or parking facility) are taken. The parties should focus on whether or not such a test is appropriate for the property at issue. The tenant should also consider negotiating for the right to keep the lease alive if the taking involves only parking and the tenant is able to acquire alternative parking rights to service the premises.

*Allocation of Award – Lease Termination.*

There are a number of possible formulas for division of the condemnation award if a ground lease is terminated as a result of the condemnation, including but not limited to the following:

- (a) That the condemnation proceeds shall be allocated between landlord and tenant as their respective interests may appear, essentially leaving it to the court to determine who gets what.
- (b) Under a common formula preferred by tenants and leasehold mortgagees, the landlord receives that portion of the award equal to the “Value of the Fee Estate,” which is defined to mean the market value of Landlord’s fee estate in the premises, determined as if the premises were unimproved and unencumbered by the lease and any monetary liens. The tenant receives the “Value of the Leasehold Estate,” determined as if the leasehold estate was unencumbered by the Leasehold Mortgage or any other lien representing a monetary obligation, and as if all Extension Options had been exercised. The value of the landlord’s fee estate should increase over time, as the term of the lease grows shorter; and the value of the tenant’s leasehold estate should decrease over time as the term of the lease diminishes. This formula, however, limits the landlord’s award to the value of the land taken, even if the lease is in its last 5 years and the landlord is shortly to acquire both land and buildings. The landlord’s ability to mortgage its fee estate will be severely limited by use of such a formula, because, no matter how valuable the landlord’s reversionary estate is becoming, the landlord’s award (and therefore the condemnation proceeds payable to the fee mortgagee) is limited to the value of the land. In addition, the landlord may be concerned that the value of the fee estate may be severely affected by temporary market conditions (e.g., a high interest rate period that depresses the real estate market), although presumably such

market fluctuations would also affect the value of the leasehold estate and the amount of the condemnation award. If such a formula is used, the landlord may want to ensure that the Value of the Fee Estate is assigned some minimum value, which takes into account the residual value of the entire premises (including both land and improvements) or negotiate a schedule of minimum values. The tenant and its lender, of course, assume some risk under that formula, because if property values drop in a way that is not taken into account in determining the schedule of minimum values, the tenant, and therefore the lender, may not receive enough of the award to repay the mortgage.

- (c) The landlord might prefer, as a starting position, a formula that allocates to the landlord the value of its reversionary interest in the entire Premises, discounted to present value; with the tenant to take the balance of the award. Tenants and their lenders generally will not favor such a formula because it may not allocate enough of the award to the tenant and lender to repay the mortgage.
- (d) Another formula that is oriented in the landlord's favor is one under which:
  - i. The landlord is entitled to the Value of the Fee Estate.
  - ii. The value of the improvements is determined, and the tenant is allocated the unamortized value of the improvements. E.g., if the lease has a term of 50 years and the lease is terminated after 10 years, the tenant is allocated 4/5ths of the value of the improvements and the landlord is allocated 1/5th of the value of the improvements. This formula may also create difficulties if the tenant wishes to obtain leasehold financing.

In all cases the value of the fee estate and the value of the leasehold estate or the value of the improvements, as the case may be, are determined at the same point in time (immediately prior to vesting of title in the condemning authority) and as if no taking was pending, threatened or under consideration.

The parties should consider that the value of the leasehold estate and fee estate may not equal the market value of the Premises (unencumbered fee simple). For example, if the ground leased building is encumbered by below-market office leases, the value of the leasehold estate would be depressed; but not the value of the fee estate. Alternatively, the ground lease could be encumbered by above-market space leases, which would have the opposite effect.

The formulas set out above are based on the assumption that the landlord is leasing vacant land to the tenant, who will build a shopping center, office building or other improvements on the land. If the landlord is constructing or funding the construction of the improvements, or if the tenant is leasing an existing building, the allocation may be very different. In all cases, however, the leasehold lender's need to recover its loan must be recognized and addressed.

*Partial Taking.* If a partial taking occurs, the lease remains in effect, the rent is reduced, the award is paid to tenant to the extent necessary to restore the improvements to an architectural whole (if the taking involves a part of the building or parking lot), and the balance of the award is divided between the landlord and tenant. Under Section 11.02, the rent is partially abated if a portion of the land is taken. The amount of the rent abatement is a percentage (to be selected by the parties) of the award for the value of the land. The percentage would generally be the same percentage used to determine the rent in a market rent revaluation (e.g. if the rent is 6% of the market value of the fee estate, the rent abatement after a condemnation would equal 6% of the portion of the award attributable to the taking of the land). Another possible method of adjusting the rent is to reduce the rent to a number equal to the stated rent multiplied by a fraction, the numerator of which is the value of the entire premises after the taking and the denominator of which is the value of the premises immediately before the taking (determined without reference to the impact of any pending condemnation).

The model form provides (Section 1.05 (b)) that if the partial taking does not include any portion of the improvements, the entire award should go to the landlord. The theory is that the land, if not improved, is essentially part of landlord's fee estate and should be paid to the landlord. The theory has some appeal if the land taken cannot be developed and is not used in the operation of the improvements, but tenants will generally strongly object to this formulation on the ground that a taking of land could substantially adversely impact the tenant's development plans, that its lender will not agree to such a division, and that the land, being subject to the lease, is still part of the tenant's leasehold estate.

The tenant may wish to negotiate for the right to terminate the lease for a partial taking that occurs toward the end of the lease. The Committee's view was that, in view of the rarity of condemnations, this would be "overkill." However, should a tenant successfully negotiate for the right, the landlord should (a) exclude minor takings (such as street takings) and (b) ensure that it is paid the entire award if tenant terminates the lease.

*Temporary Taking.* If there is a temporary taking that ends before the lease expiration date (whether or not a substantial taking), the lease remains in full force and effect and the award is paid to the tenant (who must continue to pay full rent). If the temporary taking is substantial and extends beyond the lease expiration date, the lease is terminated as of the date of the taking and the entire award is paid to landlord. If the temporary taking is not substantial and extends beyond the lease expiration date, the portion of the award allocable to the period prior to the expiration date belongs to the tenant and the portion allocable to the period after the expiration date belongs to the landlord.

### ARTICLE XIII. ESTOPPEL CERTIFICATES

In any long term lease it is essential that both parties be able to obtain from one another an estoppel certificate certifying as to the status of the lease. The landlord will

need estoppel certificates for potential fee mortgagees and buyers. The tenant will need estoppel certificates for prospective lenders, assignees, and subtenants. Accordingly, the lease gives each party the right to obtain estoppel certificates from time to time.

#### ARTICLE XIV. MORTGAGES

Article XIV first provides that the landlord may mortgage its fee estate in the premises, unless it has given a Subjected Fee Mortgage.

The balance of the Article provides for leasehold financing. A ground lease must be financeable. Otherwise the tenant will be unable to obtain money for the construction of the building and its improvements, and prospective buyers of the lease will be unable to obtain acquisition financing. Because ground leases are a much riskier form of collateral than land (for example, leases can be terminated), the lender will want to know that it has the benefit of certain lender protections, including the right to a new lease if the lease is terminated or rejected by reason of default or bankruptcy.

Accordingly, the lease must both allow the tenant to mortgage the ground lease (Article XIV) and contain customary lender protections (Article XV). Many leasehold mortgages are securitized – that is, they are transferred to an investment vehicle that consists of a pool of mortgages. These pools are rated by rating agencies. To achieve a satisfactory rating, the ground lease, leasehold mortgage, and the companies insuring the premises must all meet the requirements of the ratings agencies. The rating agencies that currently rate such investments are Moody's, Standard and Poors, and Fitch. Each rating agency has its own (if similar) requirements for ground lease investments. Those requirements can be found at their home webpages, currently [www.moodys.com](http://www.moodys.com), [www.fitchratings.com](http://www.fitchratings.com), and [www.standardandpoors.com](http://www.standardandpoors.com).

Insurance companies financing ground leases must also comply with the requirements of New York Insurance Law §1404(a)(4)(A) and §1404(a)(4)(A)(ii), which limit insurance company investments in leasehold mortgages to those transactions in which: (a) the lease term is at least 21 years, (b) the unexpired portion of the lease term is at least 20 years, (c) there are no prior liens (thus preventing a loan against a property encumbered by a prior fee mortgage), (d) there is no condition or right of re-entry or forfeiture, not insured against, under which the lender will not be able to continue the lease for its term, (e) the principal of the loan is to be repaid within the lesser of (1) 40 years or (2) prior to the expiration of 80% of the term of the lease; and (g) payments of interest and principal conform to a statutory formula.

See also 12 CFR 560.3 for requirements applicable to federal savings associations (the lease, including renewal options, must have a term that extends at least five years beyond the maturity of the loan in order to be classified as a real estate loan); and Banking Law 235(6)(i) for requirements applicable to state chartered savings banks (the remaining term of the lease, including renewal options that are exercisable at the "exclusive discretion" of the savings bank, must be at least 21 years; principal payments

must be made at least once a year and be sufficient to amortize the loan over a period not to exceed 4/5ths of the remaining lease term).

Article 14 (Sec. 14.02) provides that the tenant may mortgage the ground lease to any “Institutional Lender,” a term that is defined in Sec. 1.02(i). The lease does not prohibit the tenant from mortgaging the lease to any other kind of lender; but only an “Institutional Lender” will be entitled to the benefit of the leasehold lender protections contained in the lease.

Section 14.03 requires the landlord to give the leasehold lender a mortgage on its fee estate as security for the loan made to the tenant. The landlord should have no personal liability on the loan, but its fee estate serves as additional collateral for the loan made to the tenant. THIS PROVISION ONLY SHOULD BE INCLUDED IF THE LANDLORD HAS AGREED TO GIVE THE LEASEHOLD LENDER A MORTGAGE ON THE FEE. Whether the landlord will grant such a mortgage will be very much a matter of the landlord’s negotiating leverage and the market. If the property is marginal and the tenant anticipates that its leasehold lender will require maximum security, the tenant may need such a right. If the tenant is a well capitalized and well known developer with good relationships in the lending community, such a provision may be completely unnecessary.

#### ARTICLE XV. LEASEHOLD LENDER PROTECTIONS

Because a lease is a contract right, which can be lost through default, bankruptcy, voluntary termination of the lease by landlord and tenant, and other events, leasehold lending is inherently riskier than lending secured by a fee mortgage. Article XV is intended to give the leasehold lender, who may have invested many millions of dollars to build the project, the protections it needs to minimize its risk.

Section 15.02 requires the landlord to give each leasehold lender a notice of any tenant default. The reason for such a requirement is obvious.

Section 15.03 provides that the landlord will not terminate the lease following a tenant default, if the lender notifies the landlord that it will cure the default and then cures the default within the specified period. This section takes into account the fact that the lender may need time to obtain possession of the premises in order to effect a cure; and also provides specifically that, if the lender succeeds to the tenant’s estate (e.g., through foreclosure), the lease will not be terminated if the lender fails to cure a default that is not curable (such as a bankruptcy). The landlord should not be surprised if the tenant asks for longer cure periods. Institutional lenders need time to evaluate problems and make decisions, so they usually demand significant cure periods. The landlord should consider requiring the lender to institute foreclosure proceedings and to apply for appointment of a receiver within an agreed time period.

Section 15.04 gives the lender the right to abandon its cure efforts and relinquish its interest in the premises. In such event, the landlord is authorized to terminate the lease.

Section 15.05 provides that neither the lender, nor a designated affiliate of the lender, shall be personally liable for performing the tenant's obligations under the lease, even if it succeeds to the tenant's interest in the lease.

Section 15.06 reiterates that the lender is under no obligation to cure the tenant's defaults.

Section 15.07 requires the landlord to give the leasehold lender a New Lease if the ground lease is terminated for any reason or if the lease is rejected or disaffirmed in any bankruptcy or insolvency proceeding. The right to a New Lease is essential because without it the lender loses its loan collateral. If the landlord gives the lender a New Lease, the lender must cure any tenant defaults (except for those that cannot by their nature be cured by the lender – e.g., a bankruptcy default). Two issues are raised by this provision. First, the lender is essentially given two bites at the apple (a lender that has failed to timely cure defaults under Section 15.03, can still resurrect the lease under Section 15.07 once it is terminated). Accordingly, the landlord might want to modify the lease by limiting the lender's right to a New Lease to a situation in which the lender has continuously exercised its cure rights under Section 15.03. Second, the landlord might want to include a provision requiring the lender to reimburse it for all its reasonable expenses, including reasonable attorneys' fees and disbursements and court costs incurred by landlord in connection with the tenant's default, the termination of the lease, tenant's bankruptcy (if any) and the preparation of the New Lease. The committee's experience is that the latter provision, although fair to the landlord, is not customary and would present a problem for a lender. Accordingly, it was not included.

Section 15.09 prohibits the landlord from entering into "space leases" at the building after termination of the lease and prior to execution of the new lease, unless the lender has consented to the new leases. If the landlord does execute such leases and the lender subsequently executes a New Lease, the landlord must transfer the leases, security deposits, etc. to the lender.

Section 15.10 deals with the situation in which there is more than one leasehold lender. It provides for the *seriatim* offer of a New Lease to each leasehold lender in order of priority.

Section 15.13, among other things, prevents the landlord and tenant from terminating the lease without the lender's consent, and provides that the lender is not bound by any agreement to the contrary.

Section 15.14 gives the leasehold lender the right to assign the lease without the landlord's consent. Without this right, the leaseholder lender could not market the lease, and its security would be valueless.

Section 15.15 provides that all fee mortgages are subject and subordinate to the ground lease and the leasehold financing.

Section 15.16 gives the lender the right to control distribution of insurance proceeds, and also provides that the proceeds will be applied to the restoration of the premises and will be paid out in accordance with the procedures set out in the loan documents (usually, progress payments). Any excess insurance proceeds not used to restore, and not paid to the bank, belong to the tenant.

#### ARTICLE XVI. DEFAULT.

Article XVI is the default provision. It provides fairly customary time frames, by ground lease standards, for cure of defaults. However, if the monies spent by the tenant far exceed the value of the land and the tenant is making a significant investment, the tenant will want to make it very difficult for the landlord to terminate and will want to avoid any risk of loss through a technicality. There are many possible solutions to the tenant's problem. For example, the tenant might seek to limit the landlord's default remedy to a lawsuit for damages and entirely eliminate the landlord's right to terminate; or at least eliminate the right to terminate for non-material, non-monetary defaults. Alternatively, the tenant might negotiate for a provision that gives the landlord the right to terminate only if there is a judgment in favor of landlord and the tenant fails to cure within some period of time after final judgment is issued.

The default clause includes no cure period for Tenant's failure to comply with the initial construction timetable. That is because Section 5.06, which sets out the timetable, includes its own cure period.

#### ARTICLE XVIII. REMEDIES.

Article XVIII is sets out the usual remedies for default, including a right to damages. As is customary with ground leases, the landlord has the right, if not the obligation, to liquidate its "deficiency" damages (the difference between the lease rent and the reletting proceeds) by accelerating the rent obligation, deducting fair market rent, and discounting the result to present value. The lease is structured to allow the landlord to set the appropriate discount rate, which the landlord will generally wish to be low enough to reflect the interest rates payable on safe investments. The landlord might also set the discount rate at a rate per annum equal to the interest rate then applicable to United States Treasury bonds having a maturity date closest to the scheduled Expiration Date (without regard to any unexercised Renewal Options).

#### ARTICLE XIX. BROKER.

Tenant represents that it hasn't dealt with any brokers other than the brokers designated in Article I of the lease, and indemnifies the landlord against any claims by other brokers who claim to have dealt with tenant. Landlord indemnifies the tenant

against claims by other brokers who claim to have dealt with the landlord, but not with the tenant. The indemnity is structured in this fashion because a landlord marketing property receives many cold calls from brokers and therefore must rely on the tenant's representation that it has not dealt with anyone other than the designated broker. The key to liability is usually not whether the landlord has dealt with the broker, but whether the tenant has dealt with the broker. The exception is the landlord who has a dispute with a former exclusive agent who has not dealt with the tenant but who claims to have an agreement with the landlord. That situation is covered by the landlord's indemnity.

#### ARTICLE XX. IMPAIRMENT OF LANDLORD'S TITLE

Tenant is not permitted to impair landlord's title. If the tenant needs to enter into any easements, restrictions or other agreements encumbering the landlord's fee estate in order to develop the project, this Section must be modified.

#### ARTICLE XXI. QUIET ENJOYMENT

The ground lease contains the usual covenant of quiet enjoyment, so long as the tenant performs its obligations.

#### ARTICLE XXII. LIMITATION OF LANDLORD'S LIABILITY

The Committee elected to limit the landlord's liability to its interest in the premises. Generally, there is very little the landlord can do to breach the lease. However, tenant may want to expand landlord's liability to include proceeds of sale and should think about its possible losses if the landlord fails, in breach of the lease, to grant any critical consents (for example, with respect to initial alterations). In addition, the tenant may ask for a reciprocal limitation of liability – that the tenant's liability be limited to its interest in the premises and the lease. Landlords should note that such a provision could be extremely prejudicial if the tenant's breach involves, among other things, a holdover or if the tenant puts rents in its own pocket that should be applied to taxes.

#### ARTICLE XXIII. WAIVER OF JURY TRIAL.

As is the custom, both parties waive their right to a jury trial.

#### END OF TERM

If the tenant holds over, the landlord is entitled to, among other things, recover all costs incurred by the landlord, including attorneys' fees, to evict the tenant. The landlord is also entitled to per diem use and occupancy in an amount equal to the fair rental value of the "Premises" (which includes the building). If the tenant fails to surrender the entire building because of a holdover by some of its tenants, the landlord is still entitled to full use and occupancy for the entire building, but agrees to offset reletting proceeds received by landlord, if any, against that liability. The tenant also agrees to indemnify the landlord against claims by new tenants for its failure to deliver possession.

## ARTICLE XXVI. MEMORANDUM OF LEASE; TRANSFER TAXES

If a lease has a term that exceeds 3 years, a memorandum of lease may be recorded in lieu of recording the entire lease. NY Real Property Law §291-c. Section 291-c sets out the information that must be included in the memorandum. A copy of the lease must be submitted to the clerk or register for inspection at the time the memorandum is submitted for recordation.

When a memorandum of lease is recorded, the landlord always has concern that at the end of the lease term, the memorandum will remain of record, creating possible title problems for the landlord. The Committee considered incorporating in the lease a number of procedures that would allow the landlord to record an instrument evidencing the lease's termination (delivery of an instrument of termination into escrow, delivery of a power of attorney from the tenant into escrow, or including in the memorandum a provision giving the landlord the power to unilaterally record a lease termination), but decided that none of the procedures were likely to be workable 100 years after execution of the lease. Accordingly, the committee simply decided to include in the lease a simple agreement by the tenant to execute such instrument upon the termination of the lease.

Tenant should bear in mind that once a memorandum of lease is recorded, a modification of the ground lease will bind a transferee of the Landlord's interest *only if* a memorandum of the lease amendment is recorded. *See* NY Real Property Law §291-cc. Section 291-cc sets out the information that must be included in the memorandum.

In New York, transfer taxes are payable with respect to any lease that has a term of more than 49 years (renewal options must be included in the calculation) if (a) the lease is for all or substantially all of the real property, and (ii) substantial capital improvements are or may be made for the benefit of the tenant. By statute, the tax is paid by the grantor (the landlord), but the grantee (tenant) has liability if the grantor fails to pay. The tax is based on a present value computation of the rent, although the landlord should consult with a tax specialist to determine if the tax can be reduced through an alternate computation if the present value computation of the rent generates a number that is higher than the fair market value of the property. *See* Article 31 of the New York State Tax Law. Local transfer taxes may also be payable with respect to the ground lease (e.g., Title 11, Chapter 21 of the New York City Administrative Code). The model ground lease requires the tenant to pay the transfer taxes, but generally the tenant will negotiate for the landlord to pay them.

## ARTICLE XXVIII. EXTENSION OPTIONS

Typically, a ground lease has an initial term, and the tenant is granted the option to extend the lease term one or more times for negotiated renewal periods. The length of each extension term and the number of extension options granted must be inserted into the provisions of Article XXVIII. The parties must also determine how far in advance notice must be given.

The tenant is required to pay any transfer tax that becomes payable in connection with the extension of the term.

The tenant's exercise of each extension option is subject to a number of landlord-oriented conditions: (1) tenant must give advance notice (the time limit is specified by the parties), time being of the essence; (2) tenant is not in default of the lease unless the default is cured within the applicable cure period; and (3) tenant has not been more than 30 days late in payment of Base Rent and Taxes more than an agreed number of times. The second condition, in particular, is often a matter of negotiation. The tenant will generally want the right to exercise the option as long as the lease hasn't been terminated.

A strong tenant will negotiate for a second bite at the apple if it fails to timely exercise its extension option, by extending the time within which it may exercise the option to a date 30 (or other number) of days after landlord gives tenant notice that it has failed to timely exercise its extension option. The tenant may also want the landlord to give such notice to any leasehold lender.

The rent is reset for each extension term in accordance with the provisions of Exhibit 2, which is described below. Basically, Exhibit 2 contains 2 reset provisions, and the parties choose one or the other, or a combination of both. The parties may reset the rent at a percentage of the land value or pursuant to a CPI formula. There are many different ways to reset rent, and the committee elected to use 2 fairly common methods. Note that the formula for resetting rent for an existing building that is ground leased (rather than vacant land that is being ground leased) is unlikely to be a percentage of the land value.

Article 28 provides that if, at the commencement of the extension period, there is a dispute between landlord and tenant as to the correct amount of the base rent, the tenant will start paying base rent at the amount determined by landlord, pending determination of the dispute. Tenants will generally negotiate to eliminate this provision, to continue paying rent at the old rate, or to "split the baby" pending resolution of the dispute, with interest to accrue on any overpaid amount.

#### EXHIBIT 2. BASE RENT RESET.

Typically in ground leases there is a fixed rent, with fixed step ups during an initial period. The rent is then reset at periodic (e.g. 20 year) intervals to reflect changes in land value, inflation, etc. Typically the rent resets are tied into either a percentage of the land value (e.g., 6% of land value) or changes in the consumer price index ("CPI"). Although lenders may be more comfortable with CPI increases because they are more easily analyzed, increases in the CPI may bear no relation to the real estate market. A tenant who has agreed to periodic CPI increases may, in an inflationary era, find themselves holding a property with decreasing market value but rapidly increasing reset rents tied to the CPI.

Paragraph 1 provides for payment of rent from the Commencement Date. Often, however, tenants pay only a percentage of the rent during the construction period (with a negotiated outside date for the commencement of full rent payments), and sometimes the tenant does not pay any rent for an initial rent concession period after construction has been completed.

Ground leases are generally negotiated so that a relatively low rent is paid during the initial term, giving the developer/tenant cash flow support in the early years of construction and lease-up. It is in the later years that the landlord generally is given the opportunity to bring the rent into line with the value of the property. Accordingly, the lease will provide for periodic rent re-sets. There are many different kinds of rent re-set provisions and the methods used can be as creative as the parties are imaginative.

Paragraph 2 provides that the reset rent will be the greater of (a) the base rent payable during the last year of the immediately preceding period, and (b) the “Reset Rent,” which is determined through the formula set out in Paragraph 3.

Paragraph 3 presents two alternative formulas that are currently in common use for undeveloped land: (a) resetting the rent at a percentage of “Land Value” and (b) increasing the rent to reflect increases in the Consumer Price Index. Paragraph 3 also provides for an alternative method to reset the rent, which is based on increases in the Consumer Price Index. The index used is the Consumer Price Index published by the Bureau of Labor Statistics of the United States Department of Labor, for All Urban Consumers, U.S. City Average, All Items (1982-1984). New York City landlords might instead prefer to the Consumer Price Index published by the Bureau of Labor Statistics of the United States Department of Labor, for All Urban Consumers, All Items, New York, N.Y. – Northeastern, N.J. – Long Island, NY- NJ-CT-PA (1982-1984). The CPI rent re-set provides a more foreseeable rent increase, but will probably not allow the landlord to receive rent commensurate with the value of the land – at least in a hot real estate market.

The Land Value formula is a percentage of the appraised “Land Value.” In the decades of the 1960s, 1970s, and 1980s, the percentage was generally in the 4-6% range. In the 1990s and at the beginning of the new century, such percentages have increased. The land value is determined through an appraisal mechanism, and is determined on the basis of the highest and best use of the property. There is bracketed language which would require the appraiser to value the property without reference to any change in zoning effected after the Commencement Date. Such a provision can work for or against either party, depending on whether zoning is changed to increase development rights or to decrease development rights. If the developer builds a 10-story building that is the maximum size building permitted under existing zoning laws at the Commencement Date, he or she will usually want to be sure that any change in zoning that permits construction of a larger building will not be taken into account when Land Value is determined. See *Ruth v. S.Z.B. Corporation*, 2 Misc. 2d 631, 153 N.Y.S.2d 163 (Special Term, N.Y. Co. 1956), *aff'd* 2 A.D.2d 970, 158 N.Y.S.2d 754 (1st Dept. 1956). In *Ruth* the tenant, who leased property next to the Third Avenue elevated railroad, was required to build a 2-story building and to maintain the building in good condition. The tenant

could not substantially alter the building without the landlord's consent. At the time that the new rent (at 6% of the "full and fair value of the land ... which the same would sell for ... vacant and unimproved, in fee simple, ... free of lease and unencumbered. ...") was to be determined, the elevated railroad had been demolished and much larger buildings could be constructed due to zoning changes. Accordingly, the value of the land, as limited by the lease restriction requiring the tenant to maintain a 2 story building, was considerably less than the value of the land unencumbered by the lease, since a high rise building could now be built on the property. The court held the parties to the lease language, and determined that the valuation must be made without any consideration of the use restrictions contained in the lease because the lease expressly provided that the land was to be valued as if unencumbered by the lease. The court also stated (in dictum) that although legal restrictions on the use of the land may ordinarily be considered in determining fair market value, in this case the court was precluded from doing so by the express language of the lease. The moral of this case, of course, is that if a ground lease limits in some way the tenant's use of the property, the tenant must be sure those limitations are taken into consideration in any valuation of the property.

On the other hand, if the property is an area that is "down zoned," the inclusion of such a provision benefits the owner because the land will be valued at a higher usage than is actually possible given the current zoning. See *New York Overnight Partners, L.P. v. Gordon*, 217 A.D.2d 20, 633 N.Y.S.2d 288 (1st Dept. 1995), *aff'd* 88 N.Y.2d 716, 649 N.Y.S.2d 928 (1996), in which the First Department construed a ground lease provision calling for a determination of the "appraised value of the land." The tenant owned the building and leased the land. The property had been zoned downward after the execution of the lease, in that the existing building, although a legal nonconforming use, was larger than could have been constructed under current zoning laws. The lease defined the word "land" to specifically exclude improvements. The court held that the appraiser must determine the value of the land as though vacant, without improvements. The court also stated that although land value should ordinarily be appraised at its highest and best use, the fair market value must be determined with reference to any existing restrictions on the land, including the term of the lease and current zoning regulations. The court emphasized that because this lease clearly indicated that the value was to be determined as if the property was raw, vacant land, the beneficial impact on the value of the property of the existing nonconforming use could not be considered. Before the Court of Appeals, the landlord argued that the land should be valued alone, but as if a building could be built upon it that was the same size as the existing (nonconforming) building (which the landlord argued was its highest and best use). The Court of Appeals affirmed the appellate court's decision, noting that the appraisers must take into account all restrictions (including zoning restrictions and the lease term) *if the lease so dictates* and emphasizing that because the lease clearly intended the land to be valued as if raw and vacant, the appellate court was correct in its decision.

Tenants often raise the following issues, among others:

1. If the ground lease requires the tenant to use the premises for a specific use (e.g., office use or residential use), the tenant should ask that the market value of the land be determined with reference to the specified use.
2. To avoid being confronted with the situation faced by the tenant in *Ruth v. S.Z.B.*, the tenant may also request that the market value of the land be determined as if (a) the maximum number of square feet that can be built on the premises is the same as an agreed number, which number would be consistent with the square footage contemplated by the parties at the execution of the lease, or (b) the zoning affecting the property was unchanged from the date of execution of the lease (see bracketed language in Exhibit 2).
3. Imposing a cap on the revalued rent.

The model ground lease does not incorporate any provisions dealing with the possible effect on marketability of pending zoning changes, including (in New York City) a pending Landmarks designation, although pending changes affect, subject to a possible time lag, market prices. A New York City or other landlord who wishes to discount the effects of such pending changes, must modify the definition of either (a) Market Value (as set out in Sec. 1.01(k)) or (b) Land Value (in Exhibit 2) to reflect same.

The lease is now drafted so that the development rights appurtenant to the Premises are included in the value of the land for purposes of periodically resetting the rent or resetting the rent at renewal (Exhibit 2 ties fair market value into the value of the "Premises," which is defined to include the entire premises including development rights). If, however, the tenant acquires development rights from another property owner and pays the full cost of the acquisition of the development rights, the increased value resulting from the acquisition of the development rights should not be considered in resetting the rent in connection with periodic step ups in rent and any exercise of an option to renew. If, on the other hand, the landlord pays some or all of the cost of such transfer, its investment should be considered in the determination of the fair market value for purposes of resetting rent.

In general, if the landlord and tenant cannot agree on the appropriate land value, the ground lease will call for each party to appoint an appraiser and the dispute to be resolved by the 2 appraisers. The form ground lease imposes a late fee on a party who fails to timely deliver his, her or its appraisal of land value. The late fee could be, among other things, a flat number, a percentage of the base rent, or a flat number increased periodically to reflect CPI increases. Because ground leases are typically long term arrangements (often 99 years), any fixed late fee may, as a result of inflation, become a minor charge if it's not adjusted in some way, rather than serve as a deterrent to late delivery of the appraisal. Accordingly, the late fee is escalated throughout the lease term by a CPI Index. The parties should bear in mind, however, that although late fees may be helpful, the real deterrent to misbehavior is the potential for having the other party's appraiser decide the re-set rent if the other party fails to timely perform its obligations.

If the 2 appraisers do not reach agreement, the lease must include a mechanism to resolve the dispute. There are a number of ways to resolve the dispute including the following: (1) appointment of a third appraiser by the parties' appraisers to break the deadlock (the parties could apply to Supreme Court for appointment of a third appraiser if the appraisers cannot agree on the identity of a third appraiser), (2) arbitration of the dispute before one or more arbitrator-appraisers, and (3) arbitration of the dispute before one or more arbitrator-real estate lawyers. The Committee elected to have disputes between appraisers arbitrated because the use of NY CPLR Section 7601 to have a judge appoint the third arbitrator may be problematic. The provision is not much used and a quick decision is unlikely to be forthcoming.

The model ground lease form includes a baseball style dispute mechanism, under which the third party decider must choose either the landlord's number or the tenant's number and cannot pick a third number out of the air; because the use of such baseball style arbitration or appraisal will tend to keep the parties honest in their initial submissions of land value.

If the dispute is arbitrated, the parties should bear in mind that the more arbitrators used to resolve the dispute, the greater the cost of the arbitration, since the parties will be paying the arbitrators' fees as well as the fees of their own appraisers and lawyers. Although use of 3 arbitrators may reduce the likelihood of an irrational and arbitrary decision by a single arbitrator, it will also significantly increase the time and expense of resolving the dispute. Arbitration itself is quite expensive. Under the standard commercial fee schedule (as of 2007), the filing fee where the amount in controversy exceeds \$10,000,000 is \$12,500 plus .01% of the amount of the claim above \$10,000 (capped at \$65,000) and the case service fee is \$6,000. The parties also pay the fees of the arbitrator. As of 12/07, the NYC AAA offered a Pilot Commercial Fee Schedule under which the parties pay a lower fee on the assumption that the case will settle before hearing, but pay additional fees if the case goes to hearing. The NYC AAA also has a new program in place for 2008, which is considerably less expensive, under which the parties can use the AAA solely to select the arbitrator and not for hearing services.

If the dispute is arbitrated, the usual procedure is to have the dispute arbitrated by an appraiser arbitrator. The advantage to use of an appraiser arbitrator is that the arbitrator will have significant experience in appraisal matters and should not have any difficulty understanding the parties' positions and making an informed decision. The difficulty with the procedure is that the community of appraisers who do this kind of work is often fairly small, and there exists the possibility that the relationships among members of the group will affect the decision-making. Use of a real estate lawyer as the deciding arbitrator should tend to avoid any "old boys club" mentality; but has the drawback of the decider being a person with a background in business and the law rather than appraisal. The Committee opted for use of an appraiser as arbitrator because it is more traditional, but thought that use of a real estate attorney to act as arbitrator might work just as well or better.

Note that in setting out qualifications for appraisers, descriptions of specific expertise may be as important as the list of qualifications.

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