



REAL ESTATE

Ground Lease Armageddon

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I write about commercial real estate negotiations, deals and legal issues.

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If a developer defaults and a leaseholder leadership steps in, does the landlord still have a completion guaranty? (Photo by Wathiq Khuzaie /Getty Images) [-] GETTY IMAGES

When an owner and a developer negotiate a ground lease for a development project, the second most important issue they will consider

(after the rent) relates to the completion guaranty that the developer will need to give the landlord. That guaranty should come from a creditworthy guarantor. It helps assure the owner that the developer will complete and pay for its project. Nearly all ground leases require completion guaranties. Most also say the guarantor must always meet an objective financial test (net worth, etc.) until the developer has built and paid for its initial development project.

Before the developer starts work, the developer will typically put a leasehold mortgage on its ground lease, to obtain construction financing. If the developer defaults on the construction loan, the lender can foreclose and take over the developer's interest in the ground lease and the project. The owner's interest under the ground lease remains unscathed.

If the developer defaults on the ground lease, the owner will eventually have the right to terminate it. First, though, the owner must give the developer's lender a chance to either fix whatever problems the developer caused, or foreclose on the developer's interest in the ground lease and get rid of the developer completely, probably by finding a new developer. If the lender doesn't exercise those protective rights within a certain time, then the owner will eventually have the right to terminate the ground lease and kick everyone out.

Going into the deal, the construction lender knows that if the developer stops paying rent, the lender will need to make those payments to preserve the ground lease. The same is true if the developer stops maintaining insurance or performing other ordinary obligations under the ground lease.

What if the ground lease goes into default because, after some time, the guarantor no longer satisfies whatever financial test applies? If that happens, the owner wants to be able to declare a default under the ground lease, just like any other default. The lender will then need to fix

that default, by delivering a new guarantor that meets the financial test. And who might that guarantor be? If the lender can't find some other guarantor, the lender might need to step up and act as the guarantor itself – not an appetizing prospect at all because lenders never want to guarantee anything. But if the lender doesn't come up with a new guarantor, then the lease is in default, so the owner should eventually be able to terminate the ground lease and destroy the lender's entire collateral.

The lender, of course, sees things differently. The owner chose its guarantor. If that guarantor turns out to be weaker than expected, that shouldn't be the lender's problem. The owner should be relegated to a claim against the original guarantor the owner accepted. The lender shouldn't have the burden of finding a new guarantor – something that could take time and even force the lender to act as the guarantor.

For all these and other reasons, the lender and the developer will try to persuade the owner to excuse the lender from replacing a failed guarantor if the lender wants to preserve a defaulted lease. Sometimes the owner will accommodate that request, but usually not.

In recent ground lease transactions, we've resolved this debate in a way that recognizes the owner's legitimate need for a strong guarantor and the lender's lack of desire to provide one.

Under our resolution of the problem, once the defaulting developer and failed guarantor are out of the picture, the ground lease gives the lender an extended period, a couple of years, to find a new developer and guarantor. During that transition period, if the lender wants to preserve the lease, it must keep paying rent and doing everything else the lease required of the developer. But the lender is still given ample time to find a new developer and a new guarantor. Before anyone starts any major construction, though, the lender needs to deliver a replacement guarantor that passes the financial test.

This resolution of the problem gives the lender time and flexibility, protects the owner's cash flow, and should prevent the project from deteriorating. It's certainly not what the owner expected going into the deal, but it's a reasonable way to solve a thorny problem.



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I help buyers, sellers, borrowers, lenders, tenants, property owners, and other commercial real estate market participants identify and achieve their business goals. To do that, I need to understand risk, security, numbers, value, financeability, flexibility, and exit strategy. Some legal issues matter a lot and many don't. It's important to know the difference. I write extensively on commercial real estate law and practice – over 300 articles and five books on leasing, lending, and other areas, with some emphasis on ground leases. I occasionally serve as an arbitrator or expert witness in complex real estate disputes. That lets me see how transactions go wrong. Often, the problems could have been avoided by keeping it simple and following the money, but everyone got sidetracked. As a Forbes contributor, I try to tell stories that teach worthwhile lessons for real estate deals. **Read Less**

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