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Ground Lease Risks in Municipal Bond Projects: ArentFox Schiff

Ground lease structures have become a common feature of conduit financings in the municipal bond market. They provide tax advantages to projects and can be structured several different ways depending on the tax-exempt status of the parties involved.

The majority of the projects involve tax-exempt lessor structures. Since government entities and nonprofit organizations are exempt from real property taxes in most jurisdictions, a ground lease between such entities and a borrower-sponsor provides a project the opportunity to either be exempt from property taxes or subject to a payment-in-lieu of taxes arrangement, both of which can provide significant savings over the life of a project.

In higher education, universities usually utilize conduit financed ground lease structures to build student housing projects. These projects include a ground lease between a university, as landlord, and the borrower-sponsor, as tenant. The university agrees to the ground lease because, since the borrower-sponsor is responsible for repayment of the bonds and the mortgage is on the leasehold, the university can build a project on campus without incurring debt and keep the project for free once the ground lease is terminated. During the term of the ground lease, the provisions of the ground lease provides a means for the university to regulate or supervise the project and receive an annual ground lease rent.

In other industries, the issuer often owns the land and ground leases the land on which the project is to be built to the borrower-sponsor, who constructs the project and subleases it back to the issuer. Such a project qualifies for a real property tax exemption because it is owned by a government entity, and since the government entity is also tenant under the sublease, the project qualifies for sales tax exemptions on materials during construction. The issuer, as tenant under the sublease, is responsible for payment of the bonds, while the borrower-sponsor develops and operates the project pursuant to terms and conditions of agreements with the issuer. The borrower-sponsor usually has an opportunity to purchase the land and project once the bonds are paid.

These structures present unique risks to bond buyers. The bonds are generally secured by mortgages on the leasehold and/or subleasehold estates. Bondholders should be mindful of the rights of parties to terminate the ground lease or interfere with their ability to exercise remedies. If the ground lease is terminated or the trustee cannot take possession of the project, the corresponding lien on the physical project is extinguished and the collateral package has no value.

With that in mind, bondholders should seek the following protections in any ground lease that is part of a municipal bond financing:

- **Term** – the term of the ground lease should be at least five years beyond the maturity date of the bonds, and bondholders should push for more if at all possible. The extra five or more years allows for a workout and extension of the term of the bonds in the event it is needed to allow the project to cash flow to cover operating expenses and debt service. If the bonds on a project have a bullet

maturity, the term of the ground lease should be at least double the term of the bonds to allow for a refunding of the maturing bonds.

- **Authorization** – the ground lease should explicitly authorize the borrower-sponsor to incur a mortgage on the ground lease or else a court would consider the lien on the leasehold estate invalid.
- **Transfer and Assignment** – the ground lease should be assignable by the trustee without limitations. Failure to include such provisions could prevent a mortgagee from selling or transferring the leasehold estate (by sale or otherwise) upon foreclosure or the execution of an assignment-in-lieu of foreclosure. It is important for the provisions to allow for the trustee to designate another entity to take position in lieu of the trustee since the financing structure may rely on the status of borrower-sponsor to preserve the tax-exempt status of the bonds and/or provide other tax benefits. Additionally, such designee should be entitled to a new lease to aid in the restructuring of the project upon foreclosure or assignment-in-lieu of foreclosure.
- **Notice and Opportunity to Cure** – any notice of default by the tenant under the ground lease should be provided to the trustee, and the trustee should have an opportunity to cure of at least 30 days. An uncured event of default of tenant under the ground lease usually grants the lessor the right to terminate the ground lease, which would eliminate the trustee's collateral. A notice and opportunity to cure allows the trustee to preserve its collateral and later seek reimbursement for such expenses of borrower under the leasehold mortgage, trust indenture or other bond documents.
- **New Lease** – if the ground lease is terminated for any reason, like termination upon default, or is rejected in bankruptcy, the trustee should have the opportunity to enter into a new lease on the same terms.
  No Modification – the ground lease should not be permitted to be modified without the consent of mortgagee, or else the landlord and borrower could modify mortgagee rights and remedies without mortgagee's knowledge or consent.

In our experience representing bondholders, most of the ground leases we have reviewed have included the foregoing provisions. As we have encountered more complex financings, we have seen the following serious issues:

- **Cross-Default** – the ground lease and sublease must not cross-default with the trust indenture, loan agreement or any other bond document (Example: "A default under the Trust Indenture is a default under this Lease…"). Any event of default under the bond documents should provide the trustee the chance to exercise remedies, not give the landlord the opportunity to eliminate the leasehold estate and, as a result, the collateral, unless the trustee cures borrower-sponsor's default.
- **Third Party Beneficiary** – the ground lease and sublease should recognize the trustee and any successor trustee as third-party beneficiaries. This can be done by including a provision that designates any leasehold mortgagee as a third-party beneficiary that can enforce the agreement against the landlord and the tenant. Leasehold mortgagees are not parties to the ground lease, so a third-party beneficiary designation is required to enforce mortgagee protections in the ground lease and sublease against the landlord and tenant in court. Additionally, if success of the project is dependent on the landlord and borrower-sponsor meeting certain standards or offering certain services under the ground lease or sublease, the third-party beneficiary designation is necessary for the leasehold mortgagee to enforce those provisions against the parties if they fail to meet expectations.
- **Borrower Notices and Consents** – if the project is a lease-sublease structure where the borrower-sponsor is the tenant under the ground lease and the landlord under the sublease, the borrower-sponsor should have no consent rights on any mortgagee matters under the ground lease or the sublease. The borrower-sponsor as ground lease tenant and sublease landlord is more of a

passthrough entity for the project until the bonds are paid, while the borrower-sponsor as developer and manager is a true party-in-interest to the project. Just as developers and managers usually do not have consent rights to modifications of the collateral, the borrower-sponsor should not have those consent rights to the mortgage in the project. It grants the borrower-sponsor serious leverage in a workout against bondholders. If the borrower-sponsor has consent rights over mortgages in the sublease, for example, it could prevent the execution of a mortgage on the subleasehold estate over unpaid management and developer fees that are subordinate to debt service.

- **Shared Parcels** – the ground lease and sublease should be on their own subdivided plot, not part of a larger fee estate parcel. When ground lease projects are part of a larger fee estate parcel, the project is at risk of unrelated actions and charges on the fee estate. For instance, if a landlord that has ground leased part of the fee property to a project, funded by bonds and secured by a leasehold mortgage, decides to develop the rest of the property on the fee estate and secure it by a fee mortgage, a foreclosure of that fee mortgage would extinguish the leasehold and subleasehold estates. Similarly, if the landlord's fee project incurs taxes, utility charges, homeowners association fees or other costs that have the potential to become "super liens" superior to the leasehold estate, a foreclosure of those liens would terminate the ground lease and sublease. If the ground lease and sublease must be part of a larger fee parcel, the ground lease and sublease should (a) require that any mortgage or lien placed on the fee interest is subordinate to the ground lease, (b) require that the landlord promptly pays any charges or fees that risks the leaseholds, and (c) allow for the borrower-sponsor and the leasehold mortgagee to cure charges on the fee estate and seek reimbursement from the landlord.
- **Multiple Mortgagees** – The ground lease should recognize the potential for multiple mortgagees and prioritize the most senior mortgagee. We have encountered projects with multiple mortgagees where the mortgagees do not have an intercreditor agreement. In those cases, either the subordinate mortgagees are subordinate to the senior mortgagees based on time of recording and the other bond documents, or the subordinate mortgagees have a springing security interest that attaches once the senior bonds are paid off. Because there is no intercreditor agreement, the deal is silent as to negotiation procedures upon an event of default. Subordinate mortgagees, who usually have a closer relationship with the borrower-sponsor and misaligned interest with the senior mortgagees, too often take the reins negotiating with landlords in a workout without notifying or consulting the senior mortgagees. Either the ground lease should clarify that the landlord will prioritize the most senior secured mortgagee in negotiation and dispute resolution, and/or an intercreditor agreement with clear guidelines should be recorded on the project.

Before investing in a ground lease project, bondholders must fully understand the project and its risks. While reviewing the official statement and engaging with the underwriter, this client alert should serve as a comprehensive checklist of issues that should be addressed. In the context of a limited offering, perspective purchasers of the bonds have leverage to request our suggested changes to the ground lease. In those transactions, most landlords are related parties that directly benefit from the conduit financed project. It would generally benefit landlords for the projects to succeed, and a failure to negotiate in good faith or a termination of the ground lease with a leasehold mortgage would negatively impact their reputation and rating in the bond market. If any of these protections are not included when the bonds are issued, it is critical to obtain them in a workout as a condition for forbearance or refinancing.

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