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Making Sure the Ground Tenant Builds

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Once the building on a ground-leased property is completed, the ground landlord has a very secure rent stream. While the rent under the ground lease is based on the value of the unimproved land, if the ground tenant defaults and the tenant's lender does not step up and cure the default, the landlord's remedy is to terminate the lease and to retain ownership of the land and the building free and clear of the tenant's interest, which would typically far exceed the value of the land. As a result, ground lease defaults are few and far apart.

But what about the period before the building is built? During this period, the landlord's interest is far less secure. The tenant in most instances will be a single-purpose entity with no material assets other than its interest under the ground lease. At that point, if the tenant were to default, the landlord's remedy would be to terminate the lease and recover possession of the land. This might entail drawn-out litigation with the tenant, dealing with a tenant bankruptcy, and perhaps recovering possession of the property with liens for taxes and mechanic's liens filed for initial work that might have been commenced.

So how does the ground landlord protect itself? One method, which is most commonly used when the landlord is a governmental authority, is for the landlord and tenant to enter into a so-called "pre-lease agreement" or "agreement to lease," pursuant to which the landlord and tenant agree to enter into a ground lease in a fully negotiated and agreed-upon form upon the tenant's satisfying specified conditions within a specified timeframe. These conditions would typically include the tenant's closing on its debt and equity construction financing. They might also include the tenant's entering into agreements with architects, engineers, and a general contractor or construction manager, the awarding or buying out of a specified percentage of subcontracts, completion (or completion to a specified stage) of the plans for the building, etc. While having the above in place does not guaranty that the building will be built or give the landlord the ability to cause the building to be built, it should give the landlord comfort that the likelihood is that the building will be built, particularly where the participants are experienced and resourceful players. The tenant, however, could view a pre-lease agreement (particularly if the landlord is not a governmental authority) as imposing an additional risk, since it will have to spend substantial time and money in order to put into place all of the pieces necessary to satisfy the conditions to entering into the lease, without having the lease itself in place. It would have only a covenant of the fee owner to enter into the lease, which is not self-enforcing. The tenant's concern can, to an extent, be addressed by structuring the pre-lease agreement as an escrow agreement, pursuant to which a third-party escrow agent holds in escrow the executed lease, as well as a memorandum of the lease and any ancillary documents necessary to record the memorandum, pending the tenant's satisfying the conditions to their release.

In ground lease transactions that do not use a pre-lease agreement, the lease itself will often require that the tenant satisfy conditions similar to those described above prior to commencing construction and further provide for termination of the lease if they are not satisfied within the required timeframe. This is intended to prevent the tenant from starting to build unless and until the pieces are in place that make it likely that the construction, once commenced, will be completed. This does not, however, give the landlord assurances that the tenant will voluntarily surrender possession if the conditions are not timely satisfied. For that, the landlord might require that the tenant post a letter of credit in an agreed amount to secure its obligations under the lease, including its obligation to surrender the premises if it is unable to satisfy the conditions to commencing construction. The lease might provide for return of the letter of credit when the conditions are satisfied, or at a later point when substantial completion or some other construction-related milestone is achieved.

Another typical requirement is a completion guaranty in favor of the landlord, posted by a creditworthy affiliate of the tenant, pursuant to which the guarantor guaranties to the landlord that the building will be completed. At first blush, such a completion guaranty might not seem to impose significant additional exposure because, in most cases, the project's construction lender will require the posting of a completion guaranty running in its favor. Since the building only needs to be built and paid for once, it might seem that, provided the two completion guaranties are crafted so as to avoid duplicate recoveries, a second guaranty in favor of the landlord would add little to the guarantor's overall exposure. This, however, is not the case. Under a completion guaranty running in favor of a construction lender, unadvanced amounts of the construction loan allocated to construction costs, as well as any reserves held for that purpose, will typically be credited against the guarantor's obligations. A completion guaranty under a construction loan is essentially a guaranty of cost overruns and the guarantor will have no liability thereunder to the extent that the building can be completed for the amount allocated in the project's construction budget (see my article, "**Exposure and Remedies under Completion Guaranties**," *REF News and Views*, November 22, 2019, for a detailed discussion of the guarantor's exposure under a construction loan completion guaranty). The ground landlord, however, is not funding the construction and has no access to the unadvanced loan proceeds or reserves. Accordingly, the landlord will want its completion guaranty to cover the entire cost of construction, without any credit for unadvanced loan proceeds or reserves. This presents the guarantor with a risk of an entirely different magnitude.

Is there a way to structure a ground lease completion guaranty so that it provides the landlord with a sufficient level of comfort that the building will be completed while limiting the guarantor's risk to a tolerable level? While the risk of cost overruns that a construction lender covers with a completion guaranty is primarily a back-end risk (*i.e.*, that the construction loan will not be sufficient to fund completion of the building) the ground landlord's risk is more of a front-end risk. Once the tenant's construction lender has advanced a substantial portion of its loan, the landlord should have a substantial level of comfort that the lender will see to it that the project is completed, in order to avoid a default under the ground lease, the resulting termination of the ground lease and the forfeiture of the lender's investment. Similarly, once the project's equity financing has been fully expended, the project's equity investor may well be willing to contribute additional funds and take other measures to assure completion of the project and avoid a forfeiture of its investment. As a practical matter, the ground landlord's risk is that the project will not proceed to the point at which the providers of the equity and debt financing are sufficiently committed.

Could an acceptable ground lease completion guaranty be structured so that it need not remain in effect over the entire course of construction and perhaps guaranty less than the total cost of construction? One alternative, assuming that the financing is structured to require full expenditure of the equity capital before any substantial debt funding, would be to provide that the guaranty will terminate upon full expenditure of the equity. The guarantor could protect itself by requiring that at the outset of the project the equity investor deposit the full amount of its commitment in an account controlled by the guarantor or its affiliate. This could potentially result in an increase in the cost of the equity capital, but the tenant might conclude that the risk mitigation is worth the cost. An alternative, although somewhat lesser, level of protection could be obtained through a reimbursement agreement with the equity investor and/or its creditworthy affiliate, pursuant to which it agrees to reimburse the guarantor for certain calls under the guaranty, which could include any calls resulting from the equity investor's failure to fund its committed capital. The landlord, however, might not think that it has sufficient protection until the construction lender funds to a specified level. While the potential forfeiture of the equity resulting from a termination of the ground lease might motivate the equity investor to contribute additional funds and take other measures to complete, there is usually a long way to go between full funding of the equity and completion of construction. And, because equity is in a first loss position, in a deteriorating market an equity investor might conclude that some or all of its investment will be lost and that there is little reason to throw good money after bad. The debt financing has priority over the equity and the lender can be more confident of recovering its investment.

If the landlord were to accept a completion guaranty that terminates when the equity is fully funded and a specified portion of the construction loan has been funded, that would reduce the guarantor's exposure in the sense that its guaranty would terminate at a point in time prior to completion of construction, but unless the guaranty also capped the dollar amount of the guarantor's liability, the guarantor would nevertheless be liable for the entire cost to complete if the construction lender never funded or stopped funding before it funded the amount that triggers termination of the guaranty. So, to put a firm limit on the guarantor's exposure, the completion guaranty would have to include a cap on the dollar amount of the guarantor's liability once the equity has been funded into the project. Although this would not necessarily assure the landlord that it can look to its guarantor until the lender has funded to the point that it is committed to completing the project, the limited completion guaranty, combined with the protections afforded by a pre-lease agreement or a letter of credit as outlined above, provides the ground landlord with substantial assurances, is far better than simply having the obligation of a single-purpose ground tenant to build, and in appropriate ground lease transactions might be enough.