CADWALADER

What's the Use (Clause)?

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Use Clauses and Sublet Provisions in Ground Leases

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A ground lease is both a conveyance and a contractual agreement between a landlord (the ground lessor) and a tenant (the ground tenant) pursuant to which the ground lessor, as the fee owner of the real property, conveys a leasehold interest in the property to the ground tenant subject to the terms and conditions of the ground lease. Ground leases are often entered into to facilitate the development of an unimproved parcel of land by the ground tenant and are therefore usually long-term leases (typically at least 50 years, often 99 years) given the time and costs associated with the construction and maintenance of the site improvements; and because at the expiration of the term, title to the land, and usually also the improvements thereon, revert back to the ground lessor. From a lender's standpoint, the remainder of the term of a ground lease should be long enough to amortize the loan and permit refinancing. The minimum rule of thumb is that the expiration of the ground lease should not be less than 20 years after the fully extended maturity date of the loan. The term of the ground lease also has an effect on the marketability of the property after a foreclosure sale. Other reasons why property owners may decide to ground lease their property include restrictions on the ability to sell land owned by certain governmental entities, issues relating to subdividing the property, tax concerns (*i.e.*, transfer taxes and capital gains) and sometimes the owner of the property is simply not interested in developing and operating the building. Ground leases present a host of financeability concerns in addition to the term of the lease, and this article will address two of these issues pertaining to limitations on permitted uses and subletting.

Among other related factors such as zoning, the value of a property that is subject to a ground lease is directly tied to the uses that are permitted under the ground lease. Generally, the permitted use will impact the improvements that may be constructed on the parcel and the income the ground tenant is able to realize from tenants (which are effectively subtenants in the context of a ground lease) and may also be a determining factor in the rent and rent resets under the ground lease itself. To the extent that the ground lessor has any right of consent over the permitted uses of subtenants, this will likely render the ground lease unfinanceable since such a consent right could severely impact the ability of a property to generate cash flow.

An overly restrictive use clause would limit the ground tenant's ability to market and lease the property to tenants that engage in certain types of businesses. For obvious reasons, limiting the types of tenants to whom the property may be leased will likely have a negative impact on the income that a ground tenant/borrower is able to be generate from the property. The permitted use clause should also be broad enough to allow a lender to realize sufficient value from the sale of the borrower's leasehold interest in the event the borrower's intended use proves not to be viable. If the borrower defaults under the loan and there is a foreclosure, it is important that the pool of prospective purchasers is not limited because this may have a negative impact on the purchase price, the proceeds of which the lender will use to pay down the remaining balance of the loan.

Given the lengthy term of ground leases and the relative unpredictability of market forces, the use clause should be broad enough to allow the ground tenant (and, therefore, also the lender or prospective purchaser at a foreclosure sale) to reposition the property if needed due to changes in market conditions. Consequently, a leasehold lender would want the permitted use provision to be as broad and permissible as possible – ideally, "for any lawful purpose." If the ground lessor insists on certain prohibited uses (*i.e.*, adult entertainment businesses and operations involving hazardous materials), such uses should be expressly set forth in the ground lease. To the extent that a ground lessor does have any type of consent right, if it is not qualified by a requirement of reasonableness, then the ground lessor need not be reasonable and may condition its consent on any number of requests, including the payment of money. Even if qualified by a reasonableness standard, such consent would nevertheless be unacceptable and unfinanceable due to the time delays and administrative hurdles of consent and the "chilling" effect on any tenants not wanting to spend the time on negotiating a lease which is subject to consent rights.

The use clause is closely tied to the right of the ground tenant to sublet. A ground lease should also not impose restrictions on the ground tenant's ability to sublease the property. The ground tenant should be permitted to sublet the property without having to first obtain the consent of the landlord, even if such consent is not to be unreasonably conditioned, withheld or delayed by the ground lessor. Lease provisions that are subject to the ground lessor's consent are problematic for a host of reasons as noted above and often invite prolonged negotiations and litigation based on disagreements on what is considered reasonable, which may result in the ground tenant losing a prospective tenant that needs to take possession of the property and start operating its business. Also as noted above, as a practical matter, it is not uncommon for ground lessors to use the request for consent as an opportunity to require various concessions and additional agreements from the ground tenant that are unrelated to the request for consent and outside the scope of the lease.

Another function of ground leases having long terms is that it is unlikely that the ground lessor that originally entered into the lease is the same person or entity that the ground tenant has a working relationship with when it's time to obtain the ground lessor's consent, and unreasonable and difficult ground lessors are not uncommon in the marketplace. Further, upon a foreclosure the lender steps into the shoes of the ground tenant/borrower and will therefore be subject to the limitations contained in the ground lease, including any restrictions on subletting. Therefore, flexibility on subletting is critical, and there should be complete freedom for the ground tenant to rent its space.

Another requirement (and needed provision in a ground lease) is the obligation of the ground lessor to provide a prospective subtenant with a subordination, non-disturbance and attornment agreement (an "SNDA") whereby the ground lessor agrees that in the event the ground lease is terminated prior to its stated expiration date, the subtenant's tenancy at the property will not also be extinguished (*i.e.*, so long as the subtenant is not otherwise in default of its sublease the ground lessor will agree to recognize the subtenant as a direct tenant). Such an agreement by the ground lessor will typically be conditioned upon the subtenant agreeing to attorn to the ground lessor if the ground tenant's tenancy under the ground lease is terminated. Most sophisticated tenants will not enter into a lease at a property that is subject to a ground lease unless they have a non-disturbance agreement from the ground lessor. This is also a financeability requirement to ensure that the property is going to continue to have tenants and generate rental income to pay the debt service. To protect ground lessors, many ground leases may condition the provision of an SNDA on minimum leasing parameters or other economic conditions as well.

While there are many financeability concerns when it comes to ground leases, for the reasons noted herein it is critical that the permitted use clause in a ground lease is as permissive as possible and there are no restraints on the ground tenant's ability to sublet the property, along with the requirement for the ground lessor to provide an SNDA.

Sustainability-Linked Loans Series, Part 3 – The SLLP Core Components in Detail

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In our June edition of *REF News and Views*, we further explored the growing field of sustainability-linked loans ("SLLs") by introducing and outlining the Sustainability-Linked Loan Principles ("SLLP") and the SLLP core components ("Core Components").

As a reminder, the SLLP were published to provide a framework of principles to help market participants understand and identify the key components in establishing sustainability-linked loans. Whilst the SLLP are recommended guidelines, they are currently still voluntary and are expected to be applied on a deal-by-deal basis depending on the underlying characteristics of the transaction.

Further, the SLLP also set out a framework, enabling all market participants to clearly understand the characteristics of an SLL. The framework is based around the five Core Components, namely:

1. selection of key performance indicators ("KPIs");
2. calibration of sustainability performance targets ("SPTs");
3. loan characteristics;
4. reporting progress against SPTs; and
5. verification.

In this Part 3 of our series, we will focus on (1) selection of KPIs and (2) calibration of SPTs of the Core Components (and, in next month's edition of *REF News and Views,* we will dive deeper into (3) loan characteristics, (4) reporting progress against SPTs, and (5) verification).

Selection of KPIs

An SLL can be made to any company that has a sustainability strategy and can be any type of loan instrument and/or contingent facility (for example, bonding line, guarantee line, or letter of credit) where there is an economic impact tied to the borrower's achievement (or failure) of predetermined SPTs. The SLL will look to reward the company for achieving the goals set out in that sustainability strategy so long as the KPIs are meaningful for the company's business and the SPTs are sufficiently ambitious.

The KPIs are the cornerstone upon which the SLL market is based. The credibility of the SLL market essentially rests on the selection of the KPIs, and KPIs that are not credible should be avoided.

As recommended by the SLLPs, the KPIs selected by the borrower should be:

- clearly defined and relevant, core and material to the borrower's business, and of high strategic importance to its future operations;
- measurable or quantifiable on a consistent methodological basis; and
- capable of being benchmarked, as much as possible using an external reference or definitions to facilitate the assessment of the SPT's level of ambition.

The SLLPs recommend that a clear definition of each KPI should be provided, which should:

- include the applicable scope or parameters;
- include the calculation methodology;
- include a definition of a baseline; and

- be benchmarked against an industry standard where feasible (such as regulatory standards, from goals and objectives set in international agreements such as the Paris Agreement or the Sustainable Development Goals).

Helpfully, the Appendix to the SLLPs contains a list of some common categories of KPIs (with an example of the improvements this category might seek to measure) that borrowers can consider when structuring their KPIs and ambitious SPTs. Examples include:

- Energy efficiency: Improvements in the energy efficiency rating of buildings and/or machinery owned or leased by the borrower.
- Affordable housing: Increases in the number of affordable housing units developed by the borrower.
- Employee engagement, diversity and inclusion: Improvement in specific long-term goals relating to improvements in diversity and training and further education.

For more examples, please see this **link**.

Calibration of SPTs

The process for calibration of the SPTs in respect of each KPI is key to the structuring of SLLs and is perhaps more important than even the selection of the KPIs. The reason is that the SPTs are key to driving behaviours and are designed to act as an expression of the level of ambition to which the borrower is willing to commit.

The SLLP states that the SPTs should be set in good faith and should remain relevant (as long as they apply) throughout the life of the loan. The SPTs should also be ambitious − namely, that:

- they represent a material improvement and go beyond a “business as usual trajectory”;
- where possible, be compared to a benchmark or external reference;
- they are consistent with the borrower’s overall sustainability/environmental, social and governance (“ESG”) strategy; and
- they are determined on a predefined timeline, set before or concurrently with the origination of the loan.

The SPTs selected by the borrower should be based on recent performance levels and be based on a combination of benchmarking approaches. The SLLPs recommend that such approaches include:

- the borrower’s own performance over time as measured against the selected KPIs – the SLLP recommends a minimum period of three years;
- the borrower’s peers – the relative positioning of the SPT against its peers where available (including average performance and best in class performance) or against industry or sector standards; and/or
- references to science – such as science-based scenarios, absolute levels or official country/regional/international targets, or to recognised best-available-technologies or other proxies to determine relevant targets across ESG themes.

All disclosures on target setting should clearly refer to (i) timelines for target achievement, (ii) baseline reference points, (iii) when recalculations will happen, (iv) how the borrower intends to reach the SPTs and (v) any other key factors that may affect the borrower achieving the SPTs.

The borrower and lenders will agree on and set the appropriate KPIs and SPTs for a transaction, and a sustainability coordinator or structuring agent may be appointed to assist the lenders in negotiating and calibrating the SPTs with the borrower.

Borrowers are encouraged by the SLLPs to seek input from an external party as to the appropriateness of the KPIs and SPTs (for example, by a pre-signing Second Party Opinion as to the appropriateness of the agreed KPIs and SPTs as a condition precedent to the SLL being made available).

Where no external input is sought, the SLLP strongly recommends that the borrower demonstrates or develops the internal expertise to verify its methodologies, including the related internal processes and expertise of its staff (which should be thoroughly documented). Naturally, this documentation should be provided to lenders participating in the loan. Market practice in relation to whether external verification is sought is still developing and varies on a deal-by-deal basis.

Closing Thoughts

In the next installment in this Sustainability-Linked Loans Series, we will continue our deep dive into the Core Components and look at loan characteristics, reporting progress against SPTs, and verification.

Recent Transactions

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Here is a rundown of some of Cadwalader's recent work on behalf of clients.

- Represented the lender on $350 million of mortgage financing for the owner of the HSBC Tower at 452 Fifth Avenue in Manhattan.
- Represented the lenders in connection with the origination of a $465 million mortgage loan secured by 36 limited and select service hotels located in 18 states.
- Represented a national bank in connection with a $146.6 million refinancing of a mortgage loan secured by a luxury apartment complex in Tampa, Florida.