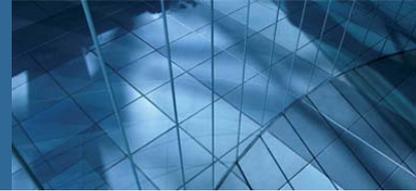




Ground Leases in Transactions, Financings and Developments

Greg Plater
Stikeman Elliott LLP
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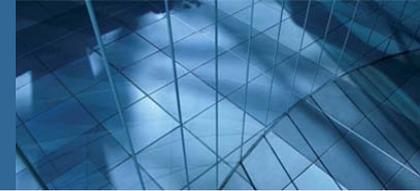
Introduction

- This presentation will outline:
 - What is a Ground Lease?
 - Why are Ground Leases used?
 - Development issues under Ground Leases
 - What makes a Ground Lease financeable?
 - The critical issue of damage and destruction
 - Environmental liability and Ground Leases
 - Special issues: (i) subdivision approval; (ii) Ground Subleases; (iii) Volumetric/Airspace Parcels



What is a Ground Lease?

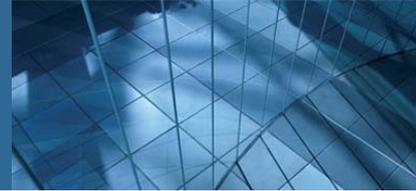
- No unique legal status for a Ground Lease - a lease is a lease
- What makes a lease a Ground Lease:
 - When they are used
 - Attributes
- When is a Ground Lease used?
 - A Ground Lease usually is a lease of undeveloped land upon which the Tenant is to build improvements
 - Differs from a design-build lease where Landlord agrees to build a purpose-built building for a Tenant, or a lease of a building or lands and buildings



- Attributes:
 - Ground Leases confer upon the Tenant many of the rights and benefits of fee simple ownership
 - Longer term than typical lease (50 - 100 years and upwards)
 - Key feature is that during the term the Tenant owns the improvements
 - Rent is based on the value of the land and not of the improvements
 - Importance of Tenant's right to sell (assign) and finance its leasehold interest is similar to the rights of a fee simple owner



- Critical difference from design-build lease:
 - is that a design-build Landlord must recover (through rent) the value of the improvements constructed
 - a Ground Lease Landlord usually receives a fixed rent payment (potentially with escalations) based on the value of the land and receives the residual value of the improvements on expiration/termination



Why Grant a Ground Lease Rather than Sell?

Landlord Perspective:

- > Retain ownership while obtaining return by way of rent and acquisition of Improvements constructed by Tenant upon reversion at the end of the term
- > Avoid development risk
- > Landlord may not have the right to sell its land (e.g. Airport Authority, most First Nations)
- > Simultaneously facilitates and allows Landlord to control development
- > Avoid unwanted capital gains tax triggered by a sale - alternative method to joint venture



- > Brings capital and expertise to development of land
- > May negotiate an equity-type interest through participation rent



Why enter into a Ground Lease Rather than Buy?

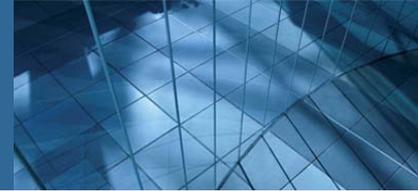
Tenant Perspective:

- Lacking resources for outright purchase and development
- Owner of land unwilling/unable to sell
- Tax benefits (expense rent under Ground Lease but claim capital cost allowance on improvements)
- Ground Lease Tenant (developer) generally will prefer fee simple interest
- Ground Lease generally more difficult to finance and sell
- Ground Lease development will involve less capital outlay by Tenant



Lender Perspective

- Ground Lease is less desirable security than a freehold estate:
 - Risk that security will be lost upon default of the Tenant (i.e. “a mortgage on a balloon”)
 - Special standards for Ground Lease financings which are subject to Rating Agency approval (see Standard & Poors Structured Finance Ratings)
 - Controls, limitations and restrictions in Ground Lease reducing realization and marketability (e.g. restrictions on assignability)
 - Lender required to honour the provisions of the Ground Lease in event of realization (including paying rent and other amounts under terms of Ground Lease)



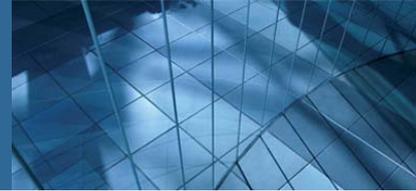
Development Issues:

- Requirements for Timely Completion of Construction
- Design Control by Landlord
- Restrictions on Use
- Damage and Destruction

Completion of Construction

- **Landlord Perspective**

- Landlord will desire completion of Project prior to a specified date, failing which the Tenant will be in default and Landlord may terminate Ground Lease:
 - substantial improvements on leased land will create incentive for Tenant to pay rent and provide cash flow for rent payment
 - if Landlord receives net cash flow participation, can only be generated by an operating project
 - Completion may be important if part of a larger development, especially retail developments
 - Landlord has strong interest in improvements being fully constructed as they will ultimately revert to Landlord upon expiration of the term on termination



Completion of Construction

- **Tenant Perspective**

- Completion date with a corresponding termination provision will be of substantial concern to potential construction lenders
- Of particular concern to construction lender who will not want to make rushed decisions in event they have to take control
- Importance of Force Majeure provisions and contractual extension rights
- Windfall to Landlord upon termination of Ground Lease and reversion of partially or fully built project - negotiation issue regarding partial payment of construction costs to Tenant

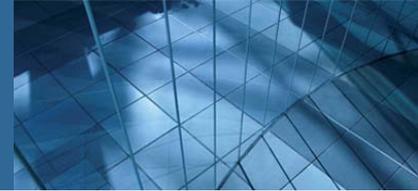


Design Control

- **Landlord Perspective**

- Level of control varies depending on nature of rent and impact (if any) on development of other Landlord lands
- Will desire the Project to be of a satisfactory design and quality (i.e. Class A office building)
- Project will ultimately revert to Landlord and Landlord may be receiving percentage rent in the interim
- Will desire the right to approve the final design of the Project and any material changes
- Landlord will want control over overall design and generally will not (and should not) have approval rights over more detailed design issues

Design Control



- **Tenant Perspective**

- Will want flexibility on project design and to avoid need for Landlord consent:
 - consent and approval of Landlord may cause disagreement and/or delays and/or additional expense
 - flexibility to accommodate economic considerations
 - flexibility to meet requirements of Subtenants
 - if rent not tied to economic performance Tenant may take position that Landlord should not be concerned with improvements as long as rent is being paid
- Lender concerns regarding Landlord consent that may impact construction, termination of Ground Lease or inability to meet needs of Subtenants



Restrictions on Use

- Allowable use provisions different than typical lease - any restriction on use beyond “lawful uses” will reduce “fee simple-like” character of Ground Lease
- **Landlord Perspective**
 - Landlord may want to restrict the use of improvements to anticipated activities
 - Improvements constructed on the leased lands will ultimately revert to Landlord
 - Landlord may be receiving a percentage rent under the Ground Lease
 - Landlord may wish to control use if it has proximate/related developments (e.g. integrated retail centre)
 - Governmental bodies may have policy reasons to promote certain types of development (i.e. affordable rental housing)

Restrictions on Use

- **Tenant Perspective**

- Tenant and lender will view restrictions as limiting value of Ground Lease and Project
- Tenant will want to have the right to use land for any lawful use on the basis that the nature of development should not matter (especially if there is no participation rent)
- In integrated developments Tenant may want Landlord to restrict use of remainder of development where tenant mix important
- Concern regarding maintaining maximum flexibility even over a long term
- Restrictions on use may adversely impact marketability and financeability





What Makes a Ground Lease Financeable and Marketable?

- The Critical Role of Disposition Provisions:
 - Assignments
 - Subletting
- Leasehold Mortgages

Assignments

- Landlord preference that assignments prohibited - on basis Tenant selected based on expertise and financial capacity
- Tenant preference for unfettered ability to assign (sell) - any restrictions impact marketability and financeability
- Tenant will want a full release from liability on assignment, especially where Landlord has approval rights
- Landlord/Tenant tension: (i) Tenant need/desire to have “fee simple-like” flexibility versus (ii) Landlord desire to retain control over identity, financial capacity and expertise of Tenant
- Link to financing: assignment restrictions will frustrate ability of leasehold mortgagee to “sell” Ground Lease in the event leasehold mortgagee realization
- Development: Landlord may require that Tenant not assign the Ground Lease until construction complete

Subleasing

- Unlike typical commercial lease sublease rights should be virtually unfettered
- Tenant will want Landlord to agree to grant non-disturbance agreements to Subtenants in exchange for Tenant agreeing to attorn to Landlord
- Generally, Landlord will give “bare” non-disturbance agreement - will avoid agreeing to be bound to comply with provisions of the subleases
- If the Tenant wants more than a “bare” non-disturbance - may be necessary for the Tenant to give Landlord some control over form and terms of subleases



Subleasing

- Tension between Tenant's ability to freely sublease and to obligate Landlord to fully recognize subleases
- Tenant's ability to finance its development is restricted if it does not have ability to enter subleases free from both the control of Landlord and risk of default

Leasehold Mortgaging

- Ability of Tenant to efficiently finance a Ground Lease is paramount. Even if no immediate intent to finance (i.e. pension funds) - Ground Lease must be financeable to be marketable
- Right to grant a leasehold mortgage should be virtually unfettered, except perhaps with respect to the type of leasehold mortgagee (i.e. restrict to financial institutions)
- Leasehold mortgagee will be interested in:
 - terms of the Ground Lease that may impact cash flow and may impact marketability on realization
 - direct assurances that the Landlord will give to the leasehold mortgagee
- Key principle: “a leasehold mortgage is like a mortgage on a balloon”. Ground Leases can not be allowed to terminate.

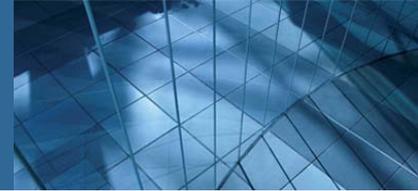


Protection of the Leasehold Mortgagee

- Leasehold mortgagee will usually require direct assurances from the Landlord - referred to as a “tri-party agreement” or “direct lender agreement”
- Key issues under “Tri-Party Agreement”:
 - preservation of Ground Lease and provisions regarding realization:
 - consent to leasehold mortgage
 - estoppel provisions confirming Ground Lease valid, subsisting and in good standing
 - Assignee of Landlord’s interest in Ground Lease (i.e. purchaser of fee simple) must assume obligations under tri-party agreement



- notice of default sent simultaneously to Tenant and leasehold mortgagee
 - leasehold mortgagee right to cure Tenant defaults
 - extended “cure period” for leasehold mortgagee
 - leasehold mortgagee not required to cure defaults which are not curable (i.e. insolvency and non-approved transfers)
- If Ground Lease terminates for any reason leasehold mortgagee may elect to obtain a new Ground Lease (“pick-up lease”)
- Pick-up lease should only be relied on as a last resort due to uncertainties:
- intervening encumbrances?
 - subleases with occupancy Tenants lost?
 - enforceable upon bankruptcy/insolvency of Landlord?
 - “Rule against perpetuities”



- Leasehold mortgagee should only be liable under Ground Lease during period that it is a mortgagee in possession and until it transfers to a third party
- Step in and step out rights
- Upon realization leasehold mortgagee must cure Tenant's defaults (monetary and non-monetary) except incurable defaults
- Prohibition against Landlord agreeing to amendments or surrender of Ground Lease
- Right of leasehold mortgagee to participate in provisions relating to expropriation, damage and destruction and disbursement of insurance proceeds



Leasehold Mortgagee's Perspective on Ground Lease Terms

- Leasehold mortgagee will review specific provisions of Ground Lease (in addition to Tri-Party/Direct lender agreement)
- Provisions of particular interest to leasehold mortgagees:
 - allowable use - will want as broad as possible
 - unfettered right to sublease
 - right of lender to participate in expropriation proceedings
 - right of lender to participate in damage and destruction situations and be involved in disposition of insurance proceeds (possible requirement for an insurance trust agreement)

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- cure periods for defaults and provisions regarding incurable defaults
 - obligation of Landlord to grant assurances to leasehold mortgagees (such as those in Tri-Party/Direct lender agreement) provision protecting Ground Lease from a prior fee simple mortgage through a non-disturbance agreement and requirement that fee simple lender recognizes leasehold mortgagee



Damage and Destruction

- Critical issue from perspective of Landlords, Tenants and Lenders
- Generally, Tenant will be obligated by Landlord to reconstruct upon any damage and destruction - especially when participation rent
- An exception may occur in the latter part of the term (i.e. last years) when Tenant may not be obligated to rebuild - in this case Landlord may require that it receives insurance proceeds



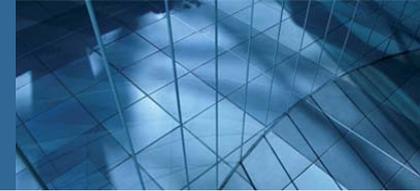
- Similar concept from space lease but different approach
- Both Landlords and lenders will want improvements rebuilt to ensure there is cash flow to pay rent
- Landlord's interest in reconstruction to ensure value of improvements at the end of the term
- Tenant is the party obligated to reconstruct
- Insurance is critical to issue of damage and destruction - insurance trustee may be appointed in order to ensure reconstruction obligations honoured and insurance proceeds properly disbursed

ENVIRONMENTAL LIABILITY ISSUES

- Most significant environmental issue under Ground Leases relates to existing or future contaminated soil and groundwater
- Lenders very sensitive to issues of environmental liability
- To address, must understand main source of liability:
 - Enforcement Orders under Part 5 of *Environmental Protection and Enhancement Act* the EPEA are current preferred regulatory tool of Alberta Environment
 - “Person responsible for the contaminated site” includes “the owner of the contaminated site”
 - Joint and several liability

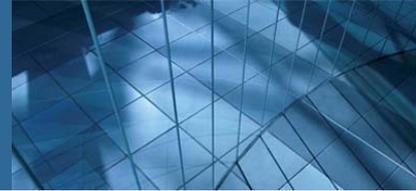


- Definition of “owner” under EPEA includes:
 - i. the registered owner, and
 - ii. a tenant or other person in lawful possession
- Landlord can be liable for Tenant’s contamination of site under EPEA
- Indirect constructive liability upon redevelopment of contaminated site

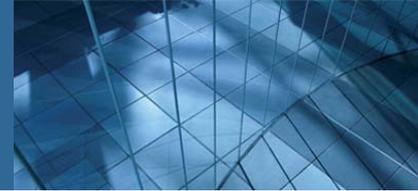


Environmental Provisions in Ground Lease

- Complexity of environmental provisions will depend on the risk of pre-existing contaminations and the risk of contamination from Tenant activities
- Two types of environmental provisions:
 - i. allocation of liability for contamination through indemnities
 - ii. obligations of Tenant throughout the term and rights of Landlord
- Both types of provisions relate to the liability risk
- Covenants (examples):
 - narrow permitted use clauses and specific environmental provisions to restrict the Tenant from actions that may result in contamination



- Tenant covenants not to use lands to deal with substances that may cause lands to become contaminated
- Landlord allowed to inspect property on an ongoing basis
- Tenant to carry out environmental site assessments at its cost at Landlord request -- complete any remedial action recommended by environmental site assessments



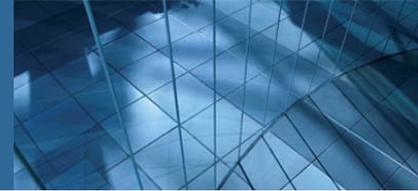
- Allocation of environmental liability:
 - Many ways to allocate liability - the key is to understand the “theory” of the transaction
 - Conventional allocation:
 - Landlord responsible for pre-term and post-term contamination
 - Tenant responsible for contamination occurring during term (even if due to actions of third parties)
 - a conventional allocation of liability will necessitate a baseline study (Phase II ESA) to establish evidence of the presence of contamination at the commencement date and a post-term study (Phase II ESA)



- “as-is where-is” allocation:
 - Tenant assumes responsibility for pre-existing contamination
 - onus on Tenant to assess existing contamination
 - no need for baseline study as Tenant assumes all liability
- Under any theory of allocation desirable to ensure that environmental site assessment conducted at the end of the term
- Parties should agree on testing and sampling protocol - consistency between baseline testing and post-term testing



- When should remedial action by the Tenant be compelled?
 - Landlord's perspective:
 - desire to ensure there is no contamination at any time
 - concern about enforcing indemnity upon termination/expiry - lack of security for obligations
 - level of concern depends on risk profile of Tenant's use (i.e. high for industrial, low for retail)



- Tenant's perspective:
 - desire to avoid remedial action unless regulators require action (i.e. through issuance of order under EPEA)
 - generally, Tenants anticipate and expect need for remedial action at the end of term - question is always "How clean is clean?"
 - Tenant should not be obligated to remediate pre-existing contamination to a higher standard than that applicable to current use
 - use of risk management methods should be adequate if regulators satisfied with this approach



- Issue of environmental risk and liability can be complex and expensive - involve experts (both legal and consulting) at early stages of negotiation
- No one way to address the issues



SPECIAL ISSUES: SUBDIVISION

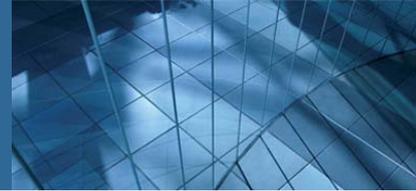
- Often parties wish to grant a Ground Lease of a portion of a legal parcel
- A grant of a long term land lease of a portion of a parcel of land may be considered a “subdivision” under the *Municipal Government Act* (Alberta)
- Issue: an instrument which causes an unapproved subdivision cannot be registered in the Land Titles Office pursuant to the *Municipal Government Act* (Alberta)



- Even if a Registrar accepts a Ground Lease of a portion of a parcel for registration, the registration may be subject to attack - risk is that Ground Lease may not be enforceable against successors in title, unlike other jurisdictions (for example, British Columbia) the issue is not one of enforceability
- Exceptions to the rule:
 - federal lands and undertakings not subject to provincial land use control (ie. airports, ports)
 - certain provincial agencies (ie. Universities) and provincial undertakings



- Impact of subsequent long term Ground Subleases of a portion of a parcel
- Subdivision required to enable raising of a separate title (desirable to facilitate financings)



GROUND SUBLEASES

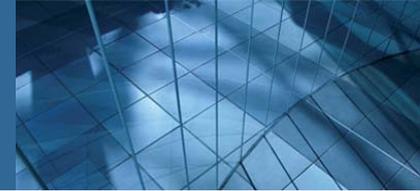
- Relatively unusual situation - arises where large existing Ground Lease to developer who wishes to essentially dispose of portions of leased lands on long term basis as if fee simple
- Examples: (i) some Government owned land - all Airport Lands across Canada; (ii) joint venture of Native Lands
- Issues analogous to any sublease but ramifications more serious
- Additional concerns:
 - Need non-disturbance from Head Landlord for Sublease
 - Need non-disturbance from any Fee Simple Mortgagee
 - Notice of default from Head Landlord and opportunity to cure with reimbursement from Sublandlord



- Special concerns regarding payment of real property taxes and forfeiture
- Concern of any action taken by Head Landlord to institute applications for land use amendments or other development approvals that may be prejudicial
- Need to insure that provisions of Ground Sublease match up with Ground Lease to avoid termination risk

Volumetric/Airspace Parcels

- Issue more likely to arise as densification occurs
- Subdivided air space parcels:
 - Municipality will ensure that basic issues relating to support, access, building code are addressed
 - Issues to address:
 - More detailed obligations relating to subjacent and lateral support
 - Reciprocal obligations relating to reconstruction upon damage and destruction where developments physically dependent on each other
 - Easements for access to premises



- Sharing of support services and utilities
 - Concept of common areas and sharing of related costs
 - Restriction on change to built form and appearance of remainder of development
- Un-subdivided parcels:
 - Issues identical to subdivided air space parcels
 - Additional risk if constitutes unapproved subdivision (which it almost certainly would)



QUESTIONS & ANSWERS

Greg Plater
gplater@stikeman.com

STIKEMAN ELLIOTT LLP | www.stikeman.com



For further information

Greg Plater
gplater@stikeman.com