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PROPERTY & THE LAW: MAKING GROUND LEASES LESS RISKY

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When an owner enters into a long-term ground lease with a tenant that is expected to erect a new building on the land, the owner is not typically worried about the long-term creditworthiness of the tenant after the building is constructed because the owner is relying on the value of the building, usually a multiple of the land value, to secure performance of the tenant's obligations.

Still, the land owner usually requires some form of security for payment of rent prior to construction, and additional security to insure that once construction has started, the building will be finished on a timely and lien-free basis. Once this occurs, the owner can breathe easier from a security standpoint and generally would not look to the credit of the tenant thereafter for performance.

After all, more often than not, construction of the building will have been financed by an institutional leasehold mortgagee, and the land would not have been subordinated or subjected to its lien. The owner can then rely on the economic incentives of the leasehold mortgagee to protect its collateral by making sure that the ground rent is paid. If it is not and the lease were terminated, the leasehold mortgages would lose all of its collateral.

The owner can also rely, at least indirectly, on the rental stream from tenants in the newly constructed building. That rental stream is usually more than sufficient to pay the ground rent, since ground rent must be paid before debt service on any leasehold.

In the worst case scenario, if ground rent isn't paid and the ground lease is terminated, the owner would become owner of the building without paying for it, free and clear of any leasehold debt.

But suppose the tenant doesn't intend to build a new building on the land, instead leasing the land and any existing buildings on a long-term basis. The owner is much more likely to worry about the creditworthiness of the tenant for a number of reasons.

First the owner wants to make sure it obtains the benefit of its bargain and that the agreed rent will be paid (remember, the owner doesn't have the security of the building which the tenant paid for as the effective collateral for the tenant's lease obligations). And second, without the security of the building, the creditworthiness of the tenant directly affects not only the overall value of the property, but also the amount of fee financing available to the owner and the interest rate paid on the financing.

Sometimes, the owner can negotiate a guaranty of the tenant's lease obligations by a parent company to provide additional security. But a long-term lease may run for a term of 20 years or more, during which time the fortunes of the tenant, as well as those of the guarantor, are susceptible to adverse change.

What else can an owner do to protect itself?

Reacting to the real estate downturn of the early '90s, mortgage lenders have been negotiating increasingly sophisticated borrower financial covenants, many of which can be adapted to enhance an owner's security under a long-term lease. Such covenants are designed to monitor the tenant's financial health and trigger additional security requirements at the first sign of trouble.

Among them:

- Required lease guaranty: If the tenant's credit standing alone isn't sufficient, the owner should determine whether this is an acceptable guarantor of the tenant's obligations. Any guaranty should require the guarantor to provide the owner, upon request, with a certified copy of its most recent financial statements. This helps the owner monitor the strength of the guarantor and provides necessary underwriting information for a potential purchaser or lender. It is helpful to the owner's financing that the guaranty also provide that if the lease should be terminated due to the tenant's default, at the request of the owner the guarantor will enter into a new lease on the same terms. This will protect the owner from breaching any provision of its fee mortgage or any proposed financing.

- Adjusted net worth: Just as a lender is concerned that the value of a borrower's equity in the real property encumbered by the lender's mortgage not be below a certain amount, the owner should make every effort to control the tenant's ability to incur more debt and/or contingent liabilities which might affect the tenant's ability to pay rent. The owner should consider requiring the tenant to covenant not to permit its adjusted net worth, at the end of any fiscal quarter, to be less than an agreed amount.

- Fixed-Charge Coverage Ration: The owner should consider requiring the tenant to covenant to maintain an agreed ratio of adjusted operating income for an agreed number of running fiscal quarters, to fixed charges for the same period. In any case, the owner's goal is not to precipitate the tenant's default and force a forfeiture of tenant's estate when rent is still being paid.

Instead, the goal is to increase the security held by the owner during periods when the tenant's rent-paying ability is susceptible to compromise. Thus, failure to meet the agreed net worth or fixed charge coverage ratio, for example, shouldn't constitute an "event of default." Instead, if the tenant breaches such covenants, the owner should consider requiring more security, perhaps in the form of a letter of credit.

The owner should also consider providing that if any transaction contemplated by the tenant, guarantor or any successor owner of the tenant would result in the tenant ceasing to be in compliance with the adjusted net worth covenant or fixed charge coverage ratio covenant, the required letter of credit should be furnished to the owner as a condition to consummation of the transaction.

To effectuate the primary financial covenants and enable the owner to effectively monitor the tenant's financial condition, the owner should consider requiring the tenant to provide its certified consolidated balance sheet and other statements of operations, stockholders' equity and cash flows as of the end of each fiscal year and quarter during the lease term.

The tenant could also be asked to certify as to whether a default has occurred under any financial covenant and set forth calculations demonstrating compliance with the fixed charge coverage ratio covenant and the adjusted net worth covenant. The tenant should furnish the owner with prompt notice of any financial covenant default, specifying the details of the default and of any proposed curative action.

The owner should protect itself by not allowing a creditworthy tenant to become less creditworthy by merging or consolidating, divesting assets, over-leveraging, or making investments deemed inappropriate. The tenant might also be prevented from up-streaming dividends or engaging in business transactions with affiliates on a less than arm's-length basis.

In sum, a long-term lease, while yielding a significant rental stream to the owner, subjects the owner and its property to the risk that the tenant may not be able to meet its payment or performance obligations under the lease. While this risk can be ameliorated by a continuing lease guaranty, it may also be appropriate to require the tenant to post additional security in the form of a letter of credit or other security if the tenant fails to satisfy periodic net worth and/or fixed charge coverage ratio tests or other agreed-upon ratios throughout the term of the lease.

The owner should consider ensuring that the amount of security that it holds at any given time corresponds to the level of risk associated with the then-creditworthiness of the tenant.

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