If it looks like a ground lease… What makes a lease a “ground lease” & why it matters - by Dena Cohen

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If you want to know the legal definition of a “ground lease” you are likely to find it defined in source material by reference to set of common characteristics associated with ground leases. At the risk of stating the obvious, the key feature of a ground lease that distinguishes it from other leases is that it’s a lease of ground, or as real estate lawyers are fond of saying: The “dirt.” However, this fact is not necessarily significant for purposes of determining financeability, transferability and other features that affect the value of the ground lease. The characteristics of ground leases include:

Long Term (generally 99 years) – Since the tenant is expected to invest substantial sums in improving the property, the lease term must be long enough to obtain financing, amortize the costs of the improvements and realize a return.

Construction – Ground leases usually involve development of new improvements (which may include demolition of existing structure) or substantial rehabilitation of improvements.

Triple Net – All operating expenses, property maintenance and repair are the responsibility of the tenant, even those obligations that are sometimes borne by the landlord in other “triple-net” leases such as the obligation to make structural repairs and capital improvements and the obligation to rebuild in the event of a casualty.

Financeability – In order to pay for the construction of the improvements, the tenant needs to finance its leasehold interest in the property. Therefore, ground leases must contain provisions that permit the tenant to obtain one or more leasehold mortgages and special leasehold mortgagee protections so that the lender can protect its collateral (e.g. right to receive notice of and an opportunity to cure any defaults by the tenant and receive a new lease if the lease should terminate).

Building Ownership – Given that the tenant is controlling the property during the extended period of the ground lease, the tenant’s position is often considered quasi “ownership” during the term. For this reason, ground leases contain fewer restrictions on assignment and generally provide latitude to the tenant in dealing with the property, such as the right to make alterations. Sometimes a ground lease provides that the building is owned by the tenant during the term but ownership reverts to the landlord when the term of the lease ends.

In an atypical ground lease, the tenant’s objective is to create a valuable income producing asset

that can be financed and sold, much the same way is if it owned the property outright. The landlord's objective is to achieve a predictable secure stream of income without assuming any development risk of operational responsibilities. These objectives have informed the characteristics of ground leases. Many if not most of the objectives of a ground lease can be realized without including the land in the leased premises. For example, nothing prevents a landlord and a tenant from entering into a lease of a building for an extended term whereby the tenant agrees to perform substantial renovations and then operate the building for the production of income while paying all of the expenses of operating the property, including making any required capital improvements. Such a lease can include virtually all of the characteristics of a ground lease, which should make the lease financeable and transferable in the same way as a ground lease. On the other hand, a lease of land can be stripped of the distinguishing features of a ground lease. For example, many ground leases place strict limits on the amount of floor area that may be included in the project, with the landlord controlling all unused development rights. Some ground leases also place limitations on the tenant's right to transfer and to perform certain types of alterations. The lease, however, remains a "ground lease" because it covers the land.

Why should it matter whether a lease is a "ground lease"?

This issue was at the heart of the dispute in a recent New York court battle entitled Little Cherry, LLC vs. Cherry Street owner, LLC, JDS Development LLC and Michael Stern (NYSCEF Doc. No. [NYSCEF] 123, Decision and Order [Mot. Seq. Nos. 002, 003].) a case that has received wide attention and in which the plaintiff, a ground lessee, was represented by Herrick, Feinstein LLP.

The critical issue in Little Cherry was whether Little Cherry, the tenant under a 49-year lease was a "party-in-interest" under the New York City Zoning Resolution with the right to prevent the fee owner of the leased property and the owner of a contiguous parcel from merging their respective zoning lots and effecting a transfer of unused development rights in connection with that merger.

The Zoning Resolution limits the buildable area of every "zoning lot" to a specified floor area ratio based on the size of the lot and its zoning district. The Zoning Resolution provides a mechanism known as a zoning lot merger, which permits the combination of zoning lots into a single larger lot, and the allocation of combined unused development rights (sometimes called "air rights") between or among the parcels in the combined zoning lot by way of a zoning lot development agreement. By adding development rights, the recipient lot increases its allowable floor area ratio, which means the owner of that lot may construct a larger building than that which would otherwise be permitted. Thus, where an existing building on one of the contiguous lots does not completely utilize the allowable floor area, a zoning lot merger could permit the developer of the contiguous lot to include that floor area in its own development.

Parties wishing to combine zoning lots, must first obtain the consent of all "parties-in-interest," which may be evidenced by execution of the declaration establishing the combined zoning lot (called a declaration of zoning lot restrictions, herein a "Declaration") or a waiver of that party's right to do so.

Under the Zoning Resolution, "parties in interest" are limited to (i) the fee owner of the land covered

by the Declaration; (ii) the holder of a recorded interest in land which would be superior to the Declaration and which could result in such holder obtaining possession of the land; (iii) the holder of a recorded interest in all or part of thereof which would be adversely affected by the Declaration; and (iv) the holder of an unrecorded interest that would be superior to and adversely affected the Declaration which would be disclosed by a physical inspection of the land.

Accordingly, under the Zoning Resolution even one who leases a building for a term of 150 years and is provided with every imaginable indication of ownership is not a party-in-interest under the Zoning Resolution as it is missing the crucial element of having an interest in the land. (Space tenants were specifically excluded from the definition of parties in interest in the New York Court of Appeals case of Macmillan Inc. v CF Lex Assocs., 56 N.Y.2d 386.)

Little Cherry involved property owned by Two Bridgeset Housing Development Fund Company and its affiliate (collectively, the HDFC Parties) which had been designated by New York City to develop the Two Bridges neighborhood under a plan for urban renewal. One of the parcels involved was leased to Little Cherry under a 49-year lease. For purposes of this discussion, the relevant history involves the attempt by the HFDC Parties and the owner of an adjacent zoning lot, Cherry Street Owner and its affiliate (Developers), to combine the zoning lots without Little Cherry's consent, based on the claim that Little Cherry was not a party-in-interest. Little Cherry opposed the development (as did the Two Bridges community who continue to oppose it) on a number of grounds, not the least of which was the proposed construction of a skyriser with a significant cantilever directly over the leased property. That triggered a lawsuit by Little Cherry for a declaratory judgment that it was a party-in-interest and that the zoning lot merger could not proceed without its consent.

The lease was triple net (including the obligation to rebuild in the event of a casualty) and contained many traditional ground lease provisions including the obligation to construct a building and the right to finance the leasehold with leasehold mortgagee protections. None of these facts were dispositive in the case. Rather, it was the definition of the "Leased Space" that carried the day and landed a valuable victory for Little Cherry. The "leased space" was comprised of two components: (i) the "store building," i.e, the building constructed on the land; and (ii) the "store site," which was defined only by reference to a hand drawn map identifying the general area where the store was to be constructed. However, given the two-pronged definition, as a matter of contract interpretation, the "store site" could not mean anything other than land.

One thing that the Developers got right in the Little Cherry case is that nomenclature should have no bearing on the rights of the parties in a transaction. The lease was not identified as a "ground leases" and in fact, the Zoning Resolution does not expressly state that a tenant under a ground lease is a party-in-interest. It's the substance that matters. Since the intent to include land in the lease was discernable, Little Cherry gained valuable protection by proving its status as a party in interest under the Zoning Resolution.

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