



Completion guaranties in ground leases, part II - by Dena Cohen

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Completion Guaranties in Ground Leases: What are they good for? (Part II)

Ground leases are considered to be secure source of passive income for land owners. What makes that income stream so secure is the fact that the tenant's obligation to pay rent is backed by an income producing property. For this reason, landlords in development ground leases care a lot about the quality of the building that will be constructed on their land, how it will be operated and perhaps most significantly, that it will actually get built. Until the building is completed, all the landlord can hope to recover in the event of a tenant default is the land, which may include a partially constructed building, with mechanic's liens, tax liens and other problems. In order to avoid this scenario, before committing their land to a particular developer, landlords need assurance that the construction will be completed. In development ground leases, that assurance usually takes the form of a completion guaranty from a credit worthy entity—often an equity partner in the tenant's venture.

At its most basic level, a completion guaranty provides that the guarantor guarantees to the landlord the timely completion of the building that the tenant is required to build under the ground lease including the payment of all construction costs of completing the building and discharging any mechanic's and other liens on the property. This may sound straightforward, but upon closer examination, the remedies available to a landlord are less clear-cut. Landlords may be unpleasantly surprised to discover that a completion guaranty does not in fact guaranty that the building will be completed.

If a tenant defaults in its construction obligation under a ground lease, the landlord will seek performance from the guarantor by demanding that the guarantor cure the default by completing the construction. If the guarantor does not perform as required, the landlord must look to the completion guaranty to determine what steps it can take to enforce the guarantor's obligation. Since the landlord bargained for a completed building, a typical remedy for breach of a completion guaranty is to bring an action to cause the guarantor to perform the construction. However, specific performance is not a viable remedy for breach of a completion guaranty for the same reason that it is not viable in other breach of contract claims; one can't force performance. Instead, the landlord could complete the construction and bring an action against the guarantor to recover the cost of completion. This would require a large upfront outlay of funds by the landlord (which it may not recover) which is

exactly what it hoped to avoid by entering into a ground lease in the first place. One way to avoid these pitfalls is for the guaranty to provide for liquidated damages in the amount of the cost to complete the construction. Liquidated damages is a common remedy in completion guarantees for construction loans. Since it involves the least risk to the obligee, it is also becoming more common in completion guarantees for ground leases. All three remedies will likely involve litigation and its attendant cost and uncertainty.

Another issue with completion guarantees is that it may not be clear from the ground lease that the tenant is in default in its construction obligation. Most ground leases have deadlines to commence and complete construction. The landlord may not have grounds to pursue the guarantor if it is not clear that the tenant is in default until the deadline. The ground lease may require that the tenant "diligently pursue" construction or similar performance standards, but the landlord would have to prove that the tenant is not acting diligently. So, even if the project is stalling, the landlord may not be in a position to enforce the guaranty until it is too late to realistically expect performance.

On the other hand, assuming the tenant obtains a construction loan (as most do), the completion guaranty will almost certainly never be enforced because it will be subordinated to the construction lender's completion guaranty and will only become relevant if the lender abandons the project which is highly unlikely except in the case of an unforeseen catastrophic event, like a severe economic downturn.

In fact, many practitioners believe that a landlord's best security for completion of a building is the existence of a construction loan made by an experienced and professional construction lender. The construction lender will be providing the primary financing for the project and will not readily walk away from its investment. Presumably, the construction lender has the resources to complete or to find another developer complete the project following foreclosure.

Completion guarantees are not going anywhere, but landlords would be well advised to require that the tenant obtain a construction loan from a qualified lender as its first line of defense. This raises the question as to what makes a lender "qualified" to provide the financing for the construction, but that is a subject for another day.

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