

REAL ESTATE WEEKLY

Don't Get Grounded Subleasing Retail Space in a Ground Leased Building

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As retailers look to establish or expand operations in developed, urban areas, opportunities may arise in mixed-use buildings and retail centers constructed on ground leased land. Before entering into any subleasing arrangements, retailers should be aware of some of the basic issues arising in these types of transactions.

Typically, the ground tenant/developer ("Sublandlord") will enter into a sublease agreement with the retailer as subtenant ("Subtenant"). In any sublease transaction, a Subtenant should ensure that the underlying ground lease does not contain any term or condition which could adversely impact the Subtenant's proposed use, operations or exit strategy.

As a matter of basic contract law, Subtenant's rights under the sublease can be no greater than the rights afforded to Sublandlord under the ground lease. Typically, a Sublandlord will provide a Subtenant with a copy of the ground lease which redacts certain business terms, such as rent, and other proprietary information. Occasionally, a Sublandlord may only furnish certain sections of the ground lease, together with its certification that these sections are true, accurate and complete in all respects. In this case, a Subtenant should attempt to secure a similar certificate from the fee owner/landlord (the "Fee Owner") under the ground lease, confirming the matters attested to by Sublandlord. A more complete copy of the ground lease is, of course, more desirable. However, in either event, the Subtenant will need assurances that all sections of the ground lease that may affect the Subtenant and its operations have been furnished, and these sections should be carefully reviewed. Some basic issues to watch out for include the sublease term, sublease recognition, landlord's lien, alterations and maintenance and replacement, overlapping insurance, and fee and leasehold mortgages.

The Subtenant should confirm that the term of the sublease, including any renewal options, does not exceed the term of the ground lease. If the sublease term could extend beyond the then-current term of the ground lease, the Subtenant should insist upon verification that all options have been exercised and/or require the Fee Owner to accept an early exercise of such renewal rights. If the Subtenant requires a minimum term which is greater than the remaining term of the ground lease, the Fee Owner may be amenable to assuming the sublease as a direct lease between the Fee Owner and the Subtenant following the expiration of the ground lease (unless, of course, the Fee Owner anticipates redeveloping the property at the end of the ground lease term). Such an arrangement could present a "win-win-win" result for the Fee Owner, the Sublandlord and the Subtenant. Material business issues of this nature

should be addressed early in the sublease negotiation process.

The sublease recognition, subordination and early termination provisions of the ground lease should be carefully reviewed to ensure that the Subtenant's rights are not extinguished upon termination of the ground lease. Many ground leases contain provisions requiring the Fee Owner to automatically recognize a sublease following a termination of the ground lease, provided that the Subtenant is not in default, the sublease is documented on a pre-approved form and the sublease rent constitutes a fair market rent. Additionally, and in lieu of a blanket recognition, the Fee Owner may agree to enter into a recognition, non-disturbance and attornment agreement with a Subtenant who meets the same criteria noted above (a "Recognition Agreement"). Oftentimes, a Subtenant will feel more comfortable with a Recognition Agreement from the Fee Owner. However, the ground lease may require the Sublandlord to pay the Fee Owner's legal fees in conjunction with such a request, and these costs may be passed along to the Subtenant. In either approach, additional provisions will be included that protect the Fee Owner from liabilities arising under the sublease prior to termination of the ground lease.

At the other end of the spectrum, some ground leases provide that a sublease automatically terminates upon termination of the ground lease unless the sublease is expressly assumed by the Fee Owner as a direct lease (which the Fee Owner is under no obligation to do). If this is the desired result, a cautious Fee Owner may want to include this provision in any recorded memorandum of ground lease (or short form lease) and/or require the sublandlord to include this provision in all subleases; however, if the provision is in the ground lease, it is not necessary to include it elsewhere.

A Subtenant should carefully consider the likelihood and impact of an early termination of its sublease absent a Subtenant default. In instances where a Subtenant (rather than a Sublandlord) will be making substantial alterations and improvements to the subleased premises, the existence of a possible early termination, due to no fault of the Subtenant, will likely cause the retailer to look elsewhere or to condition the sublease on the delivery of a Recognition Agreement from the Fee Owner so that its investment is protected.

The Subtenant also should determine whether the Fee Owner's statutory landlord's lien rights (if applicable) have been waived in the ground lease.

If not, following any default under the ground lease, a landlord's lien in favor of the Fee Owner could arise with respect to the Subtenant's property, including its trade fixtures, equipment and inventory. If the landlord's lien is not waived in the ground lease, the Subtenant should try to obtain a separate waiver from

the Fee Owner.

In some ground leases, the Fee Owner is granted the right to approve material alterations to any then-existing improvements so it can protect its residual interest following the expiration of the term. If the Fee Owner's consent is required, the sublease should be conditioned upon approval of the Subtenant's proposed improvements.

The Subtenant may also request pre-approval of future alterations to its storefront and signage to reflect future changes in Subtenant's prototypical storefront and signage designs. Since the ground lease likely includes covenants regarding the maintenance, repair and replacement of improvements, the Subtenant should understand the obligations it will be assuming in this regard.

The ground lease will require that the Sublandlord maintain liability and property insurance and may require all subtenants to comply with these provisions as well. This arrangement may be acceptable for liability insurance; however, there is no need for the Sublandlord and the Subtenant to both insure the subleased space in the event of a casualty.

If the Subtenant is only leasing a portion of building, the Sublandlord should maintain the "all-risk" insurance on the improvements, name each Subtenant (and Fee Owner) as an additional insured, and pass through the insurance costs to each Subtenant. Each Subtenant should insure its own fixtures and improvements.

The Fee Owner's interest in the property is often encumbered by a mortgage or deed of trust. Where this occurs, the Sublandlord will likely have entered into a subordination, non-disturbance and attornment agreement ("SNDA") with the fee lender to ensure that a foreclosure of the fee mortgage does not extinguish the ground lease. An SNDA may afford a measure of protection to Subtenants. However, the lender's non-disturbance or recognition obligations will likely be predicated upon the absence of a ground lease default. If a ground lease breach causes the Fee Owner to default under its mortgage, then both the ground lease and all subleases made by the Sublandlord would be subject to extinguishment or termination in connection with a foreclosure.

Where a Subtenant is making a substantial investment in new improvements, it may be advisable for the Subtenant to secure a separate SNDA or Recognition Agreement from the Fee Owner's lender.

If this isn't confusing enough, the Sublandlord's leasehold interest will likely be encumbered by a leasehold mortgage of deed or trust as well. Again, in the absence of an SNDA or Recognition Agreement between the Subtenant and the holder of the leasehold mortgage, a foreclosure under the leasehold mortgage may extinguish the Subtenant's possessory rights. ■