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## GROUND LEASE CHARACTERISTICS, SPRING 2013

### Lender Issues

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#### Characteristics of Ground Leases

A ground lease is a long-term lease of land that obligates the tenant to erect commercial or residential buildings. During the term of the lease, the tenant owns the buildings. At the end of lease, the land and buildings revert to the landlord. Ground leases are sometimes also called land leases.

The tenant pays rent for the land only, sometimes called ground rent. Since the tenant pays for and constructs the building, it does not pay rent on the value of the building; however, once buildings are erected upon the land, the lease effectively becomes a lease of both the land and building, since the tenant has all of the usual covenants to repair and maintain the building, insure it, pay real property taxes on the land and the building and deliver the building to the landlord at the end of the term in good repair. If the owner (e.g. the City of Vancouver) of the land is exempt from taxes, the lease may provide that the tenant pay a grant in lieu of taxes.

#### Examples of Ground Leases:

##### High Rise Towers

Life Companies and the like were doing them in the 50's and 60's at various undeveloped sites they owned in the lower mainland. Most of them were phased out in the later 70's and 80's by transferring the fee simple interest in the land to the tenant for the appraised value of the fee simple interest, less the value of the unexpired term of the lease. Some of these leases were for office or commercial buildings, some were for high rise residential towers. The rents were not always fully prepaid. In some cases the yearly rent was an amount equal to a certain percentage of the appraised value of the fee simple interest in the land at the time the lease was granted. The lease terms were usually 99 years.



### **Single Family Residential**

The Salish Park development on SW Marine in the late 60's on the Musqueam lands is an example of ground leases being used for single family residential development. At the time the houses were higher end single family dwellings. The terms were 99 years. In the first phase, the rents were not fully prepaid, nor was the monthly rent fixed for the entire term. The first phase leases contained fixed rent increases after the 10<sup>th</sup> and 20<sup>th</sup> years for the following 10 years. The rent for years 31 to 49 was to be based on 'a fair rental value', with the same type of review to occur after years 50, 70 and 90. The rent review after year 30 in 1995 created much controversy and animosity among the leaseholders and the Musqueam. The rent for years 31 to 49 was eventually set by a decision of the Supreme Court of Canada approximately half way between what the tenants were requesting and what the landlord was demanding. It is interesting to note that when the Musqueam granted additional leases in a second phase, the rents were fully prepaid for the entire term. Another interesting feature of the Musqueam leases is that the developer was required to not only build a house on the land, but to also service the land. This means that the valuation of the lands for the purposes of calculating the rent must assume that the land was not serviced.

### **Strip Malls**

In the 70's some of the oil companies were leasing surplus service station sites to developers for terms of 40 years. The developers would create several single storey commercial spaces on the site, or perhaps a stand-alone restaurant, line up the necessary tenants and then either keep it for their own account, or sell it to an investor. I can recall that one such landlord would have the site appraised and set the annual ground rent for each year of the term at 12% of the appraised value. At today's values, that annual rent would need to be much lower than 12%.

### **Multi Family Residential and Commercial**

The most recent examples are the False Creek and Fraser River leases by the City of Vancouver, followed by UBC on its Point Grey campus, followed by SFU on its mountain top campus. These ground leases have what is called a model strata lot lease attached to them. The developer leases vacant land, constructs a multi-unit residential building and files a strata plan. Upon the filing of the strata plan, the ground lease fractures into completely separate leases of each strata lot on the terms of the model strata lot lease. The strata corporation becomes a party to the model strata lot lease for the purpose of giving covenants in connection with the maintenance and repair of the common property. These types of leases are permitted by the leasehold strata provisions of the Strata Property Act. In order to grant this type of lease, the owner of the property and the landlord under the lease must fit the definition of leasehold landlord under Section



199 of the Strata Property Act:

“**leasehold landlord**” means the government of British Columbia, the government of Canada, a municipality, a regional district, a Nisga’a Village or the Nisga’a Nation, a treaty first nation or another public authority as defined by a regulation made under this Act;

Definitions for section 199 of the Act

12.1 For the purposes of the definition of “leasehold landlord” in section 199 of the Act, “public authority” means any of the following:

- (a) a university as defined in the University Act;
- (b) the Sechelt Indian Band established under section 5 (1) of the Sechelt Indian Band Self-Government Act (Canada);
- (c) the Provincial Rental Housing Corporation;
- (d) a board as defined in section 1 of the School Act.

The Vancouver School Board owned complex at the corners of Granville and Broadway and Granville and 10<sup>th</sup> Avenue also used this concept. The strata lots in the residential tower are the subject of model strata lot leases because a strata plan was filed, while the commercial developments including Chapters and Cactus Club restaurant are not.

My suspicion is that when first conceived, the leasehold strata concept was intended to be used for affordable housing projects, given that the landlord was to be a government body of some sort. Several of the City of Vancouver projects in False Creek were definitely of this type involving co-ops or public housing societies. Several of the City’s projects did turn out to be market housing projects and when it came to UBC getting involved in the late 80’s, it was definitely aimed more at the market housing spectrum for the Hampton Place project. More recently UBC has been attempting to create more affordable housing for its faculty and staff and building lots of student housing, the idea being to cut down the traffic flow to and from UBC each day.

### **Ground Lease Financing Issues**

#### **Term Remaining:**

Each lender has its own idea of what is safe. Most want the term remaining to be at least the amortization



period plus an additional 5 years. If the lease is just starting out, today most also prefer a 99 year term rather than say a 40 or 60 year term. Most borrowers want the longest term possible to maximize the value against which they can borrow. It is interesting to note that under the Property Transfer Tax Act (“PTT”) Regulation in respect of a lease that is not fully prepaid, the value of the value of the land and improvements for PTT purposes is effectively a percentage of the assessed value depending upon the term that is remaining on the lease at the time of registration of the lease:

Table 1

<b>Column 1 Term of Lease Agreement or Life Expectancy</b>	<b>Column 2 Percentage of Fair Market Value of the Demised Premises or the Land subject to the life estate</b>
5 years or less	40%
More than 5 years but not more than 10 years	50%
More than 10 years but not more than 20 years	60%
More than 20 years but not more than 30 years	70%
More than 30 years but not more than 40 years	80%
More than 40 years but not more than 50 years	90%
More than 50 years	100%

More than 50 years remaining is valued at 100%. Between 40 and 50 years is valued at 90%. Assuming that these values were based on appraisal principles of valuing leases, this is probably what made the surplus service station site leases for terms of 40 years viable and financeable. These percentages are for leases that are not fully prepaid. For a lease that is fully prepaid, PTT is based on the amount of the prepaid rent or on what was paid by a purchaser for the land and buildings, in the case of an assignment of an existing lease. From a lender’s perspective, if the lease is fully prepaid, the lender is more secure because in a loan default situation it is only property taxes, maintenance and repairs and other operating costs that need to be covered to cure a default under the lease.

**Landlord’s Non-Disturbance Agreement (Tripartite)**

To be financeable the landlord under the ground lease needs to be willing to sign a non-disturbance agreement to assure the lender that:

- (a) the lease is in good standing and there are no outstanding defaults when the mortgage is advanced;
- (b) the rent is fully prepaid (which is contrary to making a loan on the fee simple interest supported by





various leases, in which case the lender does not want the tenants to prepay their rent);

- (c) no material amendments will be made, nor will the lease be surrendered, without the lender's consent,
- (d) the lender will be given notice of any default and time to cure a default (sometimes a longer period than the tenant is given under the lease) with an exemption so that noncurable defaults (e.g. insolvency or bankruptcy) do not need to be remedied;
- (e) any attornment by the lender to the terms of the lease will end when the project is sold via foreclosure or otherwise;
- (f) the lender will be permitted to sell the lease to a new tenant if the lender is foreclosing on the leasehold interest;
- (g) any clauses that are in the lease that might adversely affect its security interest, should the lender or an assignee become the tenant, will be modified in respect of the lender and any assignee under a foreclosure action.

Many of the nondisturbance requirements are self-evident and very similar to the assurances that a lender wants from its borrower on commercial loans that are depending upon rental income from one or more tenants to service them. The main difference in the ground lease situation is that it is important for the lender to have the landlord who is not the borrower make these assurances as well. It is also prudent to require that if the landlord sells its fee simple interest, it will require that its purchaser enter into a new tripartite agreement on the same terms with the tenant's lender.

#### **Can the Landlord Mortgage Its Fee Simple Interest**

While rare, it is also possible that the landlord might want to mortgage its fee simple interest. This has never happened to my knowledge in the ground lease with model strata lot type of lease examples. The most likely situation in which this might occur is in a commercial situation when the ground rent is not being fully prepaid. In that case the landlord might be able to obtain a loan that was supported by the stream of payments to be made under the ground lease. Depending upon the circumstances, there might need to be a nondisturbance agreement that involves the landlord, the mortgagee of the fee simple interest, the tenant and the mortgagee of the leasehold interest. I've been involved in several examples where is also the need to include more than one lessee in the agreement to set out the priority of whose lease payments get paid to who. When the landlord receives the ground rent as a lump sum for the entire term, it has effectively sold the land for the term of the lease. Based on the lease values used for PTT purposes, if it is a 99 year



term, the landlord's interest in the reversion (the right to get the land back at the end of the term) has no value for the first 49 years of the term. Even much later into the term, the landlord would probably need to offer other security to support the loan, because there would be no revenue accruing to the landlord from the land. Perhaps the reversion under a long term lease might have some value to a lender as collateral security – perhaps not.

### **What Happens as the Term of the Ground Lease Winds Down**

There has been a fair amount of speculation about what is going to happen as the term of a long term lease winds down. Will the tenant continue to keep the building in good repair? Will the building last for the full term or will it need to be rebuilt before the end of the term? Will it continue to be saleable or financeable?

Some of the City of Vancouver's leases in False Creek shed a bit of light on this. Some of these leases had a rent review after 30 years and the terms are only 65 years. As it got closer and closer to the rent review, both buyers and lenders were not willing to get involved until they knew what the rent was going to be for the last 35 years. The City arranged for an independent appraisal to be done and gave the tenants the right to either prepay the remaining rent, or to continue to pay it in monthly instalments. I do not know the details of how they might have adjusted the appraisals to set either a prepaid amount or a monthly amount. Interestingly, in many cases the uncertainty had not deterred tenants from substantially renovating their units. When compared to fee simple units around the City, they appeared to be excellent value. I'm not certain that very many buyers or realtors selling these units truly appreciate that if the City does not renew the leases at the end of the term, all that each tenant is entitled to is to be paid the depreciated value of their strata lot and their share of the common property of the building; or, if the City does renew the lease, each tenant (or its successors) will be required to pay again for the land value at that time.

### **Conclusion**

Ground leases are in wide spread use in the Province of British Columbia. It is important that all parties (landlords, tenants, lenders and realtors) analyse and understand the short and long term implications of creating, purchasing, financing and selling interests in long term leases, prior to doing so. The implications can vary dramatically depending upon whether or not the rent is prepaid for the entire term and how many years are remaining on the term.