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Creative Solutions

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AVOIDING A GROUND LEASE FAUX PAS: Title Insurance Is Worthwhile for Ground Lessors as Well as Lessees

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Many landlords and tenants entering into long-term ground leases fail to provide for the sort of title insurance contingencies that are customarily found in purchase and sale transactions. This omission may lead to disastrous consequences for the landlord as well as the tenant. Problems are most likely to arise when a landowner leases a portion of a larger parcel to a tenant under a long-term ground lease. This situation can occur with any property type, including office and industrial buildings, hospitals, and apartments, but it most commonly arises when a retail tenant leases a parcel within a large shopping center or mixed-use development.

Listed below are some examples of title defects arising from ground lease transactions that Manatt, Phelps & Phillips, LLP, attorneys have encountered in recent years.

Illegal Subdivisions: California law prohibits the division of a legal lot into smaller parcels through a sale, lease or financing without government approval. Violators are subject to criminal prosecution and fines. Government authorities may also withhold building permits, void an executed lease and record notices of violation against the property. Interior space leases are exempt from California's subdivision law. Other exemptions apply to the construction of commercial or industrial buildings on leased land, in certain instances. However, such exemptions do not apply to every configuration of land leased for commercial or industrial use, and are not applicable to any residential developments. Additionally, even if a ground lease is initially exempt from the subdivision laws, a purchase

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Letters of Credit: No Panacea for Tenant Defaults

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Once a landlord decides to lease space to a prospective tenant, subject to receiving some security for tenant performance, what type of security must be considered in order for that landlord to receive and retain the bargained-for return on investment? Since a defaulting tenant is also a likely candidate for a voluntary or involuntary filing for bankruptcy protection, the Bankruptcy Code must be considered from the outset in structuring the deal and security accepted. Letters of credit have been tried as an alternative to cash security deposits to give landlords more protection than they would have had under the Bankruptcy Code with cash security deposits. Unfortunately, in some recent bankruptcy cases, the bankruptcy courts have not treated letters of credit differently from cash security deposits.

Security deposits held by a landlord are property of the debtor under the Bankruptcy Code § 541, and a landlord's damages for rejection of real property leases are limited pursuant to Bankruptcy Code § 502(b)(6). A large security deposit posted by a bankrupt tenant, which exceeds the maximum claim allowed under the Bankruptcy Code, will result in the landlord's being forced to turn over to the bankruptcy estate the portion of the security deposit in excess of the allowed claim. Or, as "cash collateral" the bankruptcy estate may be able to reclaim the deposit under Bankruptcy Code § 542.

Bankruptcy Code § 502(b)(6) does not permit a landlord to assert a lease rejection claim in excess of:

> (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of —
>
> (i) the date of the filing of the petition; and
>
> (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus
>
> (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates.

A letter of credit held in lieu of a cash security deposit by the tenant, such as when a lease allows a tenant to post either cash or a letter of credit as the security deposit, is likely to be held limited by the § 502(b)(6) limitation. *In re PPJ Enterprises (U.S.), Inc.*, 324 F.3d 197 (3d Cir. 2003). In another recent case, the "independence principle" set forth below won the landlord the right to draw on the letter of credit, but not to keep all of the proceeds. *In re Stonebridge Technologies, Inc.*, 291 B.R. 63 (Bkrptcy N.D.Tex. 2003). The bankruptcy judge in *Stonebridge* upheld the independence principle by stating that neither the letters of credit nor the proceeds therefrom are property of the debtor's estate. This is because letters of credit are generally subject to the "independence principle."

The independence principle provides that a beneficiary need only take the required steps to draw on a letter of credit, regardless of any disputes between the beneficiary and the issuer's applicant. The court in *Stonebridge* held that the independence principle protected the draw on the letter of credit. However, because the lease

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option in the lease could trigger a violation at a future date.

CC&Rs With Power of Termination: CC&Rs are promises to maintain real property in accordance with certain conditions that have been specified in prior deeds or other recorded documents. Some CC&Rs provide that a violation thereof will result in the reversion of the real property to the original grantor. For example, property donated to a charitable institution may contain a restriction in the original deed which provides that the property will revert to the grantor if it ever ceases to be used for the original charitable purpose. A charitable organization may unwittingly violate such restriction if it ground-leases property to a for-profit enterprise.

Lot Line Adjustments/Overlapping Ground Leases: In certain instances, a property owner may enter into multiple ground leases and/or purchase options with affiliated entities affecting adjacent legal parcels within a single development. Subsequently, the owner may reconfigure legal parcels by lot line adjustment in order to facilitate development of the site. In such cases, the owner must also amend any recorded memoranda of lease to reflect the revised legal description of the parcels. Failure to do so may result in leasehold parcels that straddle lot lines in violation of subdivision laws, and may also create overlapping leasehold interests in the same land.

Frequently, the ground lessee or its lender will identify these issues if they perform their own title review analysis. However, if the lessee elects not to obtain title insurance, or does not yet have leasehold financing in place when it enters into the ground lease, these issues may remain undiscovered for months or years.

Property owners may incur substantial legal costs to correct these problems if they are not addressed prior to execution of a ground lease and recording of a memorandum of such lease. Therefore, it may be worthwhile for the ground lessor to obtain its own title insurance policy for the ground leased parcel, whether or not the ground lessee obtains leasehold title insurance. Such title insurance policy should include appropriate endorsements that insure the owner/lessor against any loss arising from the violation of any CC&Rs or subdivision laws, or from the failure of the leasehold estate to vest in the ground lessee.

This is not common practice today, because most ground lessors will have previously obtained an owner's title insurance policy upon acquiring the land, and seek to avoid additional costs. However, an owner is not insured against damages resulting from its own acts subsequent to the date of the original policy. In addition, the value of land usually increases substantially upon entering into a long-term ground lease for such land, and it may be advisable for the owner to obtain new title insurance that reflects this increased value. Moreover, a long-term ground lease is comparable to a conveyance of real property where the seller finances 100% of the purchase price with a purchase money mortgage that fully amortizes over 30 years or more. In the latter scenario, most sellers would require a lender's title insurance policy insuring the seller/lender that title to the encumbered property is vested in the buyer/borrower, and that the seller/lender has a valid lien, subject only to approved title exceptions. Characterization of the transaction as a ground lease rather than a financing should have no effect on the owner's willingness to assume such title risks. Therefore, most ground lessors should seriously consider obtaining the type of title insurance described above when entering into ground lease transactions.

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Proposed Revisions

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although the revised ADAAG could impose new requirements on exactly what constitutes the suitable removal of a barrier.

Under the current ADAAG, public accommodations include retail stores, hotels, bars and restaurants, movie theaters, public transportation terminals, museums, parks and zoos, public schools, etc. These buildings are required to be accessible to the disabled public to the same extent they are accessible to the non-disabled public. To the extent that they are not accessible to disabled persons, they are vulnerable to federal discrimination claims. Retail stores and fast food restaurants across the country, especially in Florida, have been hit particularly hard by ADA activist organizations and plaintiffs' attorneys who have filed hundreds of lawsuits under the ADA, known in the legal community as "drive-by" lawsuits. The ADA's regulations do not currently require that advance notice be given to a potential defendant before filing a lawsuit. In resolving many cases, defendants must pay the plaintiffs' attorney fees, in addition to bearing the cost of the alterations. The extent to which the proposed ADAAG, when finally adopted, will impose additional burdens in resolving such litigation is unknown.

In commercial facilities such as office buildings, factories and warehouses, generally only those areas that are open to the public, such as lobbies and some common areas, as well as entry and egress to and from work areas, are required to be fully accessible under the current ADA and ADAAG's specifications. However, there is some indication that the proposed ADAAG may expand the requirements in these types of buildings with respect to new construction and alterations. Mixed-use public accommodations/commercial facilities are generally required to be fully accessible to the disabled public to the extent that the public accommodation and commercial facility portions of the properties standing alone are required to be accessible.

The question that remains — and requires careful analysis — is the extent, if any, to which existing public accommodations and commercial facilities that comply with the current ADAAG, but may not comply with the ADAAG finally adopted by the DOJ, will be required to remove barriers to disabled persons. Until the current ADAAG and the final ADAAG are fully compared and analyzed, the impact of the substantive changes on public accommodations and commercial facilities will not be clear, and the impact these changes will have on landlord-tenant relations must also be studied. ■

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