New York Law Journal
Real Estate Law&Practice
WWW.NYLJ.COM
An ALM Publication

MONDAY, JUNE 21, 2010

Truth in Labelling

Is that lease *really* 'triple net'?

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THE YEAR IS 1979. The parties have entered into a "sale-leaseback" transaction. As a result, the seller/tenant, usually an operating business with an investment-grade credit rating, has removed non-productive assets like land and factory from its books and turned them into cash, but nevertheless continues to have their full use in its business.

The purchaser/landlord has obtained reliable, leveragable cash flow and possibly some depreciation (pre-1986 transactions typically had tax shelter aspects). It might also get its equity out of the transaction some 10 to 20 years down the road, not coincidentally at the time when its purchase money financing becomes due.

The lease is one form of "triple net lease," typically called a "bond lease." This lease is so "net" that it practically is not a lease at all, having many of the characteristics of an investment security.

Move forward to 1989. Joe Landowner, the patriarch of his family and financially comfortable in his early 80s, has a very well-located property in Manhattan, improved with an aging "taxpayer" building. Given the amount of unbuilt FAR available at the property, in addition to the excess development rights that could be purchased from adjoining lots, Sally Developer thinks that redeveloping the property would be a huge success.

Unfortunately, Joe has owned the property for many years, and has availed himself of so many tax benefits that his tax basis in the property precludes a sale. So Joe leases the property to Sally on a long term lease that gives her most of the responsibility and freedom of a landowner, even the ability to finance with mortgage financing.

The lease might also give Sally a right of first refusal to purchase the land if offered for sale, which is likely to occur only after Joe passes away and his estate's tax basis in the property is stepped up to its fair market value. The lease is another form of "triple net lease," called either a "ground lease" or a "development lease." The lease is almost as net as a bond lease.[1]

Now scroll to the present. Landlords and brokers love to call their leases triple net, particularly outside of New York City. The tenant pays taxes, insurance and operating expenses from the first dollar, sometimes directly, as opposed to escalations over a base. The document even says that it is a net lease: that the tenant is responsible for paying all of the costs of owning and operating the property other than those that the landlord has agreed specifically to pay.

But what are the costs that the landlord has agreed specifically to pay? If the building needs roof or structural repairs, those are the landlord's obligations. And if the building burns down, the rent abates, and the landlord must either rebuild or the tenant may terminate the lease.

On the other hand, if the tenant wants to assign or sublet, or to alter the space, the landlord's consent is required (although the landlord might agree to be reasonable in certain specified contexts).

Incredibly, in some instances, the premises are only a portion of a building, rather than the entire property. In other words, except for the obligation to pay certain expenses outright, rather than as escalations, and except for the provision that says that the tenant is responsible if anything happens that the lawyers did not anticipate, these leases look very much like traditional office, retail, or industrial space leases.

Clearly, the term "triple net lease," once quite descriptive, has become very ambiguous. Rather than depicting transactions predominantly having well-settled common features, the term now conjures up more of a spectrum of "netness."

To understand this spectrum, it is helpful to understand some of the traditional features of triple net leases, as well as the variations found in typical development and bond leases.

The Traditional Triple Net

Before the term "triple net lease" had eroded greatly, it described an arrangement in which the tenant held, for a long term, all or most of the rights and obligations of the fee owner of a property, other than the record title.

The tenant was obligated unconditionally to perform all of the duties and obligations, as well as to pay all of the costs and expenses, inherent in owning, improving and operating the property. The tenant's payment obligations included all of the real estate taxes, all of the insurance costs, all of the maintenance and repair expenses (including roof, structural and exterior work) and all of the utility costs.

If the building suffered a casualty loss, the tenant was obligated to restore or replace it, even if the available insurance proceeds were insufficient to cover the cost.[2]

It mattered not that the work or cost was extraordinary, unanticipated, or even unforeseeable. The tenant must take the risk, perform the work, incur the cost and continue to pay the full rent, come what may, even if an economic condition or catastrophic event reduced or eliminated the tenant's cash flow from the property for a short or extended period.

Indeed, except in the pesky context of a condemnation, the rent under a triple net lease was never abated or reduced. As a result, the landlord's role was little more than to cash the rent checks, pay its income taxes and pay the debt service on any fee mortgage.

In exchange for its assumption of most of the burdens of property ownership, as well as in recognition of the long-term nature of the tenancy, the tenant under a traditional triple net lease was given much greater flexibility in its use, improvement and operation of the property than a traditional space tenant.

Typically, the tenant under a triple net lease was permitted to use the building for any lawful purpose or purposes, as well as to update such use from time to time as changing market conditions dictated. The tenant also had broad rights to alter the property, at least non-structurally, as its business needs dictated, usually with very few and loose conditions (such as the obligations not to reduce materially either the value of the property or the usable area contained in the building).

Further, the tenant was given practically free rein to sublet portions of the property to users, as well as the benefit of looser assignment restrictions. Typically, many of these rights were curtailed during the final years of the term.

Development Leases

Essentially, the tenant under a development lease acquires all of the economic benefits of an attractive parcel of real estate, including the

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opportunity to redevelop and reposition the property, for a long period of time and with no upfront land acquisition cost.

Rather, the "land acquisition cost" is spread over the term of the lease in the form of the net rent, which frequently starts to be payable only after the property has become productive. Indeed, it is not unusual for a development lease to require the payment of only a nominal amount of fixed rent until the new building is constructed, and then require increases as the property becomes occupied and throws off an increasing cash flow.

The tenant, however, is still required to pay the real estate taxes, insurance and other costs of the property from the inception of the lease term.

The typical development lease has most of the features of a traditional triple net lease, but also gives the tenant the right to alter the improvements on the property, structurally and otherwise, practically as the tenant sees fit. Indeed, the tenant usually is given the free right even to demolish the existing building (maybe even more than once during the term), provided that the tenant replaces the building diligently and in due course with a modern building of equal or greater value, sometimes repositioned as to character of use to reflect a changing market.

Prior to demolition, the lease might require the tenant to deliver a completion guaranty from a creditworthy guarantor, to post a cash security deposit, or both.

The financing provisions in a typical development lease are noteworthy.

Because of the tenant's need to leverage the costs of constructing a new building, the leasehold estate usually is the primary focal point for property financing. In order to render the leasehold estate financeable, the lease customarily contains provisions for the benefit of a leasehold lender. For example, the landlord agrees to give the leasehold lender copies of all notices of default and the right to cure those defaults.

Similarly, if the lender is unable or chooses not to cure a default, the lender typically has the right, for a period of time after the termination of the lease, to receive its own new direct lease for the remainder of the term, upon the same rent and other conditions as the terminated development lease.

Further, it is customary for any existing fee mortgagees to subordinate their mortgages to the lease, and for any new fee mortgages to remain subordinate to the lease. Consequently, if the fee owner defaults under a mortgage, the lease cannot be terminated in foreclosure: any successor owner takes title subject to the lease.

A development lease usually permits the tenant to assign the lease, and sublet all or a part of the premises, from time to time without consent. However, because a major inducement to the landlord is the improvement and repositioning of the property by the tenant, the lease might well restrict the tenant's right to assign or sublet until the new building is substantially completed.

The tenant might also be exculpated from liability for any leasehold defaults beyond the loss of its leasehold estate and improvements, although again the exculpation provision might not take effect until after the redevelopment of the property.

From the landlord's perspective, during the term of a development lease, it has traded the potential upside in economic benefits from redeveloping, repositioning and operating the property for an agreed-upon cash flow (typically subject to periodic fixed or formulaic increases or fair market value resets over the term) that will be unaffected by economic conditions or circumstances that might arise with respect to the property, so long as the tenant does not default under the lease.

Plus, at the end of the term (whether due to the passage of time or by reason of the tenant's default), the landlord gets the property back, improved with a better building than that at the inception of the lease.

Assuming that its reversionary interest has value, the landlord might be able to obtain mortgage financing secured by its fee title. However, because the fee mortgage will be subordinate to the lease, the net rent stream from the lease will define the maximum amount of available financing: the fee lender will consider the property's cash flow to the tenant in underwriting the likelihood that the net rent will continue to be paid, but will never lend more than the amount that can be serviced by the net rent.

The now-ambiguous term 'triple net lease' once described an arrangement in which the **tenant held**, for a long term, **all or most of the rights and obligations** of the fee owner, other than record title.

Under most development leases, the landlord and any fee mortgagee bear a significant amount of real estate risk. Unless the tenant is a creditworthy entity and is not exculpated, the obligation to pay rent is only as good as the cash flow from the underlying asset.

The risk may be somewhat mitigated by the presence of a leasehold lender who will be willing to cure defaults in order to preserve its security, but in tough economic times, leasehold lenders have been known to walk away. None of this is true with regard to the bond lease.

Bond Leases

A typical bond lease also has most of the features of a traditional triple net lease, in addition to a number of very important additional features.

First, the typical bond lease does not contain the leasehold mortgagee protective provisions that a development lease construction lender would require. Rather, financing will occur at the fee estate level, typically to leverage the landlord's purchase price for the property.

In order to better enable the landlord to obtain mortgage financing, the lease is subordinated to present and future fee mortgages, provided that the tenant obtains a satisfactory non-disturbance agreement from the lender.

Most importantly, under no circumstances may the bond lease be terminated without a corresponding obligation on the part of the tenant to purchase the property from the landlord.

If the property is condemned, if there is a major fire or other casualty loss, or if the tenant defaults and fails to cure, the tenant typically is obligated to purchase the property from the landlord, if the landlord so elects, for a price determined by a formula designed to yield to the landlord sufficient cash to retire its fee mortgage, a return on its investment and perhaps something more for the landlord's trouble.

Unlike under a development lease, where the property (as well as perhaps the interest of a leasehold mortgagee) stands as the primary security for the tenant's performance, the landlord and its mortgagee under a bond lease look primarily to the credit of the tenant and have virtually no real estate risk. The tenant is rarely if ever exculpated from liability, and might even be called upon to give covenants as to its continued financial ratings and strength, much like the issuer of an investment security.

The tenant also has limited rights to assign or sublet, if any at all. As noted above, one might consider the bond lease to be less of a real estate document and more like an investment security akin to convertible preferred stock.

Truth in Labeling

No matter the label, the " triple net" nature of a lease ultimately depends upon its financial terms and allocation of risk. It is, however, usually inaccurate and misleading to conceptualize what is essentially a space lease transaction, shift some of the payment and/or performance obligations from the landlord to the tenant, and characterize the result as a "triple net lease."

1. Over the years, ground leases have been used for many reasons unrelated to taxation. For example, some landowners simply are unwilling to part with their land, on principle if not for more concrete reasons. However, if the economics are right, they are willing to part with control over the land for a period of time. A classic example is the City of London, most of which has been developed and occupied under ground leases for hundreds of years. Ownership of the land remains one of the prerogatives of the British Crown.

2. Of course, this obligation was meaningful only if the tenant had assets other than the leasehold in question or there was a substantial guarantor as a backstop. Also, note that this requirement frequently did not apply during the final years of the term. For obvious reasons, during this period, either party was given an option to terminate the lease as of the date of the casualty loss, and the landlord was entitled to receive the amount of insurance proceeds in excess of that required to be paid to any fee and/or leasehold mortgagees.