

STEIN'S LAW

Moody's Clamps Down on Two Ground Lease Issues

In negotiating or reviewing any ground lease, one always wants to see a set of provisions that collectively makes the ground lease "financeable." That agenda has become fairly standard. The rating agencies have memorialized it in the criteria that determine whether, or how favorably, a loan can be securitized.

Even against that backdrop, two issues of financeability have drawn discussion. Both are fairly technical. One relates to a factual circumstance that, to my knowledge, has never actually arisen.

In a recent report, Moody's Investors Services made clear that if a ground lease does not handle those two issues right, Moody's will regard that as a "flaw" in the lease. That could mean higher subordination levels or conceivably even make a leasehold loan ineligible for securitization—though the consequences of these "flaws" are not entirely clear.

The first of these issues relates to the relative priorities among the rights of a landlord, a tenant, the landlord's lenders and the tenant's lenders. In an earlier column, I said there is only one right way to put together that puzzle. The lease and the tenant should have priority over any mortgages created by the landlord. The tenant's mortgages should attach only to

the leasehold so a foreclosure can't affect the landlord's interest. And the landlord's mortgages should attach only to the landlord's interest, subject to the lease, so a foreclosure can't affect the tenant's interest.

Sometimes great minds try to come up with other ways to align those four interests in real property. In its recent report, Moody's rejected such creativity. The various players simply need to line up their interests as the previous paragraph and my previous column suggest. Failure to do that will result in rating agency issues in any securitization. And nonsecuritized lenders will probably follow Moody's lead—hardly a new or pioneering position—on this issue.

The second issue in the Moody's report is even more technical. It involves the hypothetical possibility that a leasehold borrower will file bankruptcy and "reject" the ground lease—something that bankruptcy law allows but that doesn't happen much or ever in ground-lease financing. As a practical matter, nonrecourse carveout guarantees have largely eliminated these bankruptcies anyway.

If a leasehold borrower ever did file bankruptcy and reject the ground lease, this would create a big problem because the ground lease

was collateral for a leasehold loan. After rejection, what happens to the lender's collateral? It might just vanish.

Many ground leases say, if the lease "terminates," the landlord must offer the lender a new lease. That's good. But some cases say a "rejection" is different from a "termination," so some vestigial shred of the ground lease remains after rejection—so it hasn't "terminated." In that case, "rejection" might not entitle the leasehold lender to a new lease, creating confusion and uncertainty.

Moody's therefore says a ground lease should entitle the lender to a new lease if the ground lease is "rejected"—not just "terminated." If the ground lease doesn't say that, the resulting uncertainty creates a major concern for Moody's in any securitization.

One could say, though, that if some shred of the ground lease remains after rejection, then the leasehold lender's mortgage sticks to that shred, and if nothing remains, then the lease has terminated, and the lender should get a new one. A lender might take comfort from the idea that bankruptcy courts are "courts of equity"—they're supposed to "do the right thing"—and if the lender properly raises its concerns, the court should protect the lender even after a rejection driven, for example, by borrower vindictiveness.

No historical basis exists to think a court

would accept these great arguments. Few or no reported cases exist. That leaves uncertainty but also shows how rarely these issues actually arise. They could require years of litigation, first in bankruptcy court, then in state court, to resolve. The lender would probably win, but it could cost a lot; lenders wisely never rely on bankruptcy judges to protect lenders; and during litigation the lender would need to write checks to preserve its collateral.

Because of all this, Moody's suggests that if a "new lease" clause omits the crucial reference to a "rejection," then this creates a serious problem and could even make a loan nonsecuritizable.

Must the outcome be so binary? Perhaps one can estimate the likelihood the lender will eventually prevail (high) and also estimate how long any litigation should take, quantify the cost of that delay, discount everything by its improbability of ever occurring and develop a simple formula for how much to "penalize" a leasehold loan for lack of "rejection" language. A "penalty" calculated on that basis should not be high.

In the meantime, anyone negotiating a ground lease should keep in mind the importance that Moody's attaches to these issues.

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LAWLOR & ORDER

De Blasio Housing Plan—Opportunity or Illusion?

Mayor Bill de Blasio recently released an ambitious multibillion-dollar affordable housing plan and the resulting attention and criticism was quick but predictable. The shortage of housing that is affordable to people who give New York City its life (i.e., police, firefighters, teachers and artists) threatens the livability of the city. Gov. Andrew Cuomo has characterized the statewide shortage as a crisis and has vowed to commit billions of dollars to and soon will release his own plan. Shouldn't this be a time for celebration by neighborhoods and the real estate industry?

But Mr. de Blasio's efforts have encountered strong resistance, often from the people and communities these initiatives are intended to benefit. Labor unions have demanded union wages in developments that receive tax abatements. Public housing residents oppose losing parking and green space. And community boards oppose changes to the zoning ordinance.

Protesters' chants at a mayor's forum on his housing plans summarize the concern of the general public: "De Blasio's plan ain't affordable to me!" The plan has been criticized by editorials, advocates, politicians and members of the public for being too ambitious, too complicated, a giveaway to developers, a gentrification plan and not enough to make a

difference. The list goes on.

Do these criticisms mean the mayor's plan is a waste of time or a false promise? Hardly. These criticisms demonstrate that the mayor has taken on a crisis that touches nearly every resident of New York City.

The mayor's plan, if taken out of context, contains a myriad of proposals that look like a fast lane to developing new denser market rate housing throughout the city without creating many new affordable housing units. A closer look reveals not a single plan for the entire city but a wealth of options.

The mayor's plan reflects current practice and theory of urban planning—public-private partnerships to finance and develop housing units that build on neighborhood strength and, most importantly, are guided by neighborhood plans developed with citizen participation. It recognizes that affordable housing development is most impactful when it includes economic development in the form of new jobs, new businesses, economic diversity and opportunity. In order to achieve that success, there must be a neighborhood plan that considers public safety, infrastructure, green space,

schools and adult educational opportunities.

Historically, affordable housing does not have a positive public image. Ask a person on the street to define affordable housing, and they will likely invoke the image of failed "public housing projects" with all the problems that occur when poor people are warehoused in large projects isolated from the community without opportunity to advance and participate in the local economy.

Although not the case in New York City, other cities have been left with no choice but to tear down the failed projects and start over. The success of those efforts is particularly evident in New Orleans where thousands of units of public housing, decrepit and distressed before Hurricane Katrina, were rendered uninhabitable and left 80 percent of the city underwater for nearly a month.

With substantial assistance from the federal government, New Orleans successfully rebuilt its public housing developments, using a similar comprehensive neighborhood planning approach proposed in Mr. de Blasio's plan. After significant public input—which started as wide-ranging opposition, demonstrations and protests—these developments

were rebuilt in a manner that reflected and incorporated the surrounding neighborhood, provided opportunity for long-term residents to remain, included substantial private investment, brought market rate and public housing tenants together, generated construction and long-term jobs and improved the surrounding neighborhood. Although there are legitimate criticisms, the model has produced similar positive results throughout the country.

Mr. de Blasio's plan is a framework for a mind-boggling \$41.4 billion of investment in neighborhoods to finance the development and preservation of new housing for all income strata—middle-income families, seniors, homeless. However, the mayor's plan is not self-executing. It requires the participation of government, community-based organizations, lenders and developers to collaboratively develop and invest in plans that would result in the creation of new assets for communities. The mayor's challenge is to convince the neighborhood residents that his housing plan is an opportunity—not an illusion—to participate in a process that will bring positive change to their neighborhood.

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