

Grappling with a Ground Lease in the Sale of Hotel: How to Get a Grip

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Congratulations! You have been retained to represent a client in the sale or purchase of a hotel. Unlike a standard real estate deal where “fixed” land or a building is bought or sold, a hotel transaction involves a living, breathing operating business with employees, guests, inventory and existing contracts. In many ways, the sale of a hotel is more in tune with the sale of an existing business that just happens to involve real estate, rather than being like the sale of real estate that just happens to have an operating business located on the land or in the building. Coming at the deal as the sale of an on-going business will help you hone in on the key issues that you should consider in guiding your client through the transaction to the desired outcome, i.e. the successful and smooth transition of the hotel to a new owner. One of the key issues to consider is how the land on which the hotel sits is held by the Seller, as this will set the stage for negotiating the real estate portion of the transaction.

“WE HAVE A GROUND LEASE SITUATION. NOW WHAT?”

While it may seem obvious, the type of interest that the Seller maintains in the land on which the hotel is located is key to defining how to structure the real estate portion of the deal. If the hotel is situated on land which the Seller owns outright, the Buyer will merely purchase fee simple title to the land, along with the assets of the hotel. At Closing the Buyer will obtain a general or limited warranty deed to the land. Customary due diligence regarding matters of title, survey, environmental, physical (i.e. building and building systems), contractual and lease issues must be properly addressed, as in any purchase of improved real estate. However, if the land on which the hotel is situated is held as a leasehold interest subject to a Ground Lease, the deal will require a few more hoops to jump through to ensure that all the relevant parties are on board with the deal in addition to the usual and customary real property due diligence. The terms of the Ground Lease itself will determine whether the actual Landlord, likely the property owner, will have to approve the transfer of the leasehold interest and give consent for Buyer to receive assignment of the Ground Lease or whether the transfer can occur without the Landlord’s consent. As long as the hotel will continue to operate on the land, the Landlord likely will not object to the transfer of the leasehold interest to the Buyer because the Landlord will understand that rent will be paid from the revenue generated by the operations of the hotel.

Cooperation from the Landlord will be required in other regards to facilitate the deal. Buyer and Buyer’s lender (assuming there is a lender) will require that Landlord execute an estoppel certificate verifying that there are no defaults by Seller or any circumstances which could trigger a default under the Ground Lease. Additionally, the Buyer’s lender will undoubtedly request that Landlord execute a subordination agreement which recognizes the lender’s rights in the leasehold interest as collateral for the Buyer’s loan. The Landlord, who will hopefully provide the necessary consents and approvals, must be taken into account during the deal even though the Landlord is not a party to the Sale Agreement.

“LANDLORD, PLEASE RELEASE US FROM OUR GUARANTY.”

Even if no consent or approval is required from the Landlord to transfer the leasehold interest, the Seller or a parent company or other related entity of Seller may have given a Guaranty for the Lease to ensure the full payment of rent and performance of all other terms of the Lease. If the Guaranty does not expire until a date far in the future, the Guarantor will likely desire to be “released” from its obligations on the Guaranty since its subsidiary or affiliate will no longer own the hotel and the Guarantor will have no ability to influence operations of the hotel and/or ensure that no defaults occur under the Ground Lease. This may present a “sticky wicket” so-to-speak because the Guarantor will be at the mercy of the Landlord to obtain a release if the language in the Guaranty or Ground Lease does not provide for the Guaranty to expire upon the assignment of the leasehold interest in the event of a sale or transfer of the hotel and/or does not permit a substitute Guarantor. If the Seller, as Tenant, and its parent company or other affiliate, as Guarantor, have maintained a good relationship with the Landlord during the term of the Ground Lease (likely in place for many years), the Seller may be able to successfully negotiate terms for the Landlord to “release” the Guarantor from the Guaranty. Of course, this may come at a significant price, the amount of which will depend upon how much the Seller and/or its affiliate want to see the sale go through and how much the Landlord will demand, reasonably or unreasonably, to grant the release.

Obviously, the specific facts of the deal and the relationship of the parties will dictate whether a release is granted and on what terms. If the “Landlord” is comprised of various family members who may have inherited an interest in the Ground Lease from a parent or other relative, each family member will have to agree to the terms of a release of the Guarantor. The more parties that must agree to the terms of the release, the more complicated the deal could become as each party will have his or her own interests or motivations in the deal.

Should the Landlord refuse to provide a release of the Guaranty, the Seller may decide to place certain requirements in the Sale Agreement or a separate agreement in order to ensure that in the event the Buyer defaults under the Ground Lease after the Closing, the Seller or its affiliate has the opportunity to cure the default prior to the Landlord attempting to collect rent or other monetary damages from the Guarantor under the Guaranty. This scenario will certainly be much more complicated as the Seller will continue to have an interest in making sure its affiliate, as Guarantor, is not pursued under the Guaranty post-Closing. As an alternative to such post-closing arrangements involving multiple parties, it may be simpler to require a “Re-Guaranty” from the principals or parent company of the Buyer, which essentially “wraps” the original Guarantor in a protective guaranty should its Guaranty result in claims based on the Buyer’s default under the Ground Lease.

SURPRISE! DO YOU KNOW YOUR SUB-TENANTS?

On the flip side of dealing with the Landlord under the Ground Lease, the Seller and Buyer both need to consider the interests of any subtenants who may have subleases derivative of Seller’s leasehold interest in the property. The parties, and Buyer’s lender, will want to obtain estoppels and SNDA’s from the subtenants declaring that no defaults, or any circumstances which may be considered a default, exist under the subleases. You will want to make sure that all of the subtenants have been accounted for and determine whether any of the subtenants have in

turn sub-subleased their interests in the property. This can be tricky in a Ground Lease situation as the likelihood that the businesses located on the property (which may, for example, be operating a gift shop, restaurant or even a gas station on the leased land) may have changed ownership and in turn assigned or transferred their sub-leasehold interests with or without required notices and/or consents. Ensuring that a thorough title search is done is critical to any deal involving real estate. In the case of a hotel subject to a Ground Lease, even a good title search might not be enough if the derivative interests do not appear of record.

For example, it is possible that a subtenant could have sub-subleased its leasehold interest to another party, but failed to notify the Seller, as sublandlord, of such sub-sublease. As a result, Seller may not be aware of existing defaults under a sub-sublease because Seller has not been notified of the existence of the sub-sublease and has no direct relationship with the sub-subtenant. Generally, this might not be of concern to Seller as sublandlord. However, to ensure that Seller covers the possibility of any potential liability under the Ground Lease it will be assigning at Closing to Buyer, Seller will need to make sure that it has properly identified all sub-subtenants and confirmed that no potentially “harmful” defaults exist under the sub-subleases. Thus, it is critical to ensure that the parties have been properly identified and that they have no “issues” with regard to the Seller’s leasehold interest being sold. As an example, if a sub-subtenant were operating a gas station and had caused environmental contamination due to a leaky underground storage tank, Seller would need to determine if Seller had any potential liability under federal or state environmental laws for any fines, monitoring or clean-up associated with the contamination. The Buyer and its lender would want to know that the sub-subtenant who caused the contamination had accepted full responsibility for causing the contamination and paying for the clean-up and any required monitoring associated therewith. If the sub-subtenants have not properly been identified, then neither Buyer nor Seller will know the true extent of any liability, potentially great but at best unquantified, which may be transferred along with the assets of the hotel. Both the Seller and Buyer will want to make sure that they have solid indemnifications in the Sale Agreement so that neither unknowingly and unwittingly accepts responsibility for environmental liability for which it is not responsible.

Potential environmental issues are just one key item to contemplate in the sale of a hotel on ground-leased property. Another potential “issue” is the existence of any mortgages on the property. Most likely, the Seller will have a mortgage on its leasehold interest that will need to be paid off and released at Closing. It is also possible that one of the subtenants or sub-subtenants previously placed a mortgage on their interest in the property or filed UCC financing statements for equipment used on the property. Accordingly, the Buyer and its lender will want to obtain a subordination agreement with such other lender(s) to ensure that the new purchase money mortgage stands superior to any subtenant’s existing mortgage or other financing arrangements.

SUMMARY

Knowing how the real estate on which the hotel is situated is held is key to structuring the terms of the Sale Agreement for the sale of an existing hotel. In the case in which the hotel sits on land which is subject to a Ground Lease, you must scour the terms of the Ground Lease to determine if any consents or approvals must be obtained from the Landlord of the property in order to transfer the leasehold interest. If an affiliate of Seller has given a Guaranty of the

Ground Lease, you will need to negotiate with the Landlord to attempt to have the Guarantor “released” from the Guaranty upon the assignment of the Ground Lease to the Buyer at Closing. The relationship of the parties and their agendas will dictate on what terms a release is or is not given to the Guarantor. Locating all of the subtenants and any sub-subtenants must be done to ensure that there are no defaults which exist under any of the subleases that may lead back to the Seller as sublandlord. Most troublesome would be any environmental problems which may have been caused by a subtenant or sub-subtenant that could potentially flow back to the Seller and, in turn, be passed on to the Buyer if not properly protected through tough indemnification provisions.

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