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Seminar 12

Sale-Leasebacks and Financeable Leases: You Think You Own It, But You Actually Sold It — And Now You Have to Finance It

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I. Sale-Leaseback Transactions

A. Sale-Leasebacks Defined

Before discussing sale-leasebacks and financeable leases and the myriad issues related to such transactions, a brief prelude is necessary. In order to more effectively evaluate those risks, sale-leasebacks need to be defined. A sale-leaseback transaction is a real property transaction in which the owner of the real property sells it to a third party for 100% of its cash value and the buyer simultaneously leases the real property back to the seller pursuant to a long-term "triple net" lease. There are four (4) types of sale-leaseback transactions involving improved real estate[1]: (1) sale-leaseback of land and improvements; (2) sale-leaseback of land only; (3) sale-leaseback of improvements only; and (4) sale-leasebacks of land and improvements with different buyers. The sale-leaseback of land and improvements is the most common structure used, particularly for retail properties.

B. Purposes of the Leaseback (and the Sale)

The second part of a sale-leaseback transaction is the leasing back of the property that has been conveyed. It is the seller, or a designee of the seller who is also creditworthy (or has a guarantor) and will operate the property, who will be the tenant. One of the primary purposes of the leaseback is to generate capital by converting illiquid, bulk assets into a liquid asset – cash, which the seller/tenant can utilize in its business without the high costs of borrowing, whether from institutional lenders or otherwise. This allows the seller/tenant to generate a much higher return on investment for its business. Of course, the benefit is only realized to the extent that the seller has maximized the sales price of the real property.

For the purchaser of the property, it creates a guaranteed and hopefully steady cash flow which can be very attractive to someone who can rely upon the credit of the tenant. Thus, sale-leaseback transactions provide the investor with a strong, long-term return with a high-credit tenant. The new fee owner can also finance its fee position (as its position is quite secure) at a favorable rate and, in many instances, will create opportunities for like-kind exchanges at least for so long as they are permitted under the federal tax law. There may also be other tax benefits for the new fee owner, including the ability to utilize depreciation deductions.

[1] Real Estate Investor's Deskbook §9.25[1] (Revised ed.), Alvin L. Arnold and Daniel E. Feld (1982, 1987).

As for the tenant, it will get maximum flexibility beyond that normally given to operating tenants and will ensure the financeability of the leasehold position by drafting provisions (which we will discuss below) which will give comfort to the parties; the term; renewal rights; the premises; permitted uses; rent; net rent concerns; improvements; insurance/damage/condemnation; default/right to cure; assignment and subleasing; environmental concerns and special concerns of leasehold financing including: 1) right to a new lease; 2) limit on amendments and other consents by the tenant; 3) notices to the lender; 4) participation in condemnation and other potential disputes; 5) non-merger of estates; and 6) representations and warranties.

C. Who Does Sale-Leaseback Transactions?

As is often the case, the parties to sale-leaseback transactions are numerous and varied, both as sellers/tenants and buyers/landlords, and the frequency with which sale-leaseback transactions are used fluctuates with the economy.

Seller-tenants include established businesses with large portfolios of real estate, such as department store chains, big box retailers, smaller retailers with standalone locations, single user special purpose operators, and restaurants, as well as less mature businesses that are looking to expand their footprint but need additional capital to fund the expansion. For all of these parties, sale-leaseback transactions allow the company to use its capital more profitably and efficiently while still maintaining possession and control of the real estate.

Buyer-landlords often include real estate investment trusts (REITs), on the one hand, and 1031 exchange parties seeking long-term investments for gains received from the sale of other real estate. As noted above, one of the benefits buyer-landlords is an attractive return on investment by virtue of a stable, long-term tenant who pays all operating expenses of the property. In addition, because the tenant is responsible for operating and managing the property, the triple-net lease results in minimal, or at least drastically reduced, property management responsibilities for the buyer-landlord. In addition, the buyer-landlord also has the option of obtaining more favorable financing than the seller-tenant might, based on the income stream generated by the triple-net lease with a stable, credit tenant.

II. <u>Material Provisions of Leaseback</u>

A. Parties to the Leaseback

For the leaseback in a sale-leaseback transaction, the landlord under the lease will always be the new fee owner. After entering into the leaseback, the new owner is free to sell or transfer all or part of its estate. The tenant under the leaseback has no right to limit to whom the new owner may sell although, in some instances, a concerned tenant may seek to limit the right to sell the property to competitors of the operator for fear that the competitors may learn about the tenant's operations although this is highly unlikely. The tenant under the leaseback is presumably the seller although the tenant can be the operating entity. If it is the operating entity, the operator would need excellent credit or would need to have the tenant's interest under the leaseback be guaranteed by the parent company of the tenant.

B. Term

The initial term under a leaseback is generally quite lengthy. Not only do both parties want the tenant to be paying rent and operating the premises for a long time but there is generally going to be a long-term permanent leasehold mortgage, the leasehold mortgagee needs to know that if it forecloses or otherwise acquires the title after default by the tenant there is a sufficient term remaining to recoup the loan balance and interest, either through operation of law or resale. It is not uncommon for the leasehold mortgage to have a term of thirty years or more and to fully self-amortize. Renewal terms are generally provided in the leaseback after a lengthy initial term but they need to provide inflation protection or market increases (frequently determined by arbitration absent agreement of the parties) as the fee owner wants to ensure that the value of its estate and interest in the property is not diminished. Since fee purchasers in sale/leaseback transactions seek a steady by definable rent stream it is not uncommon to see, renewal rent increases, for example, of ten (10%) percent every five years. Even though this may result in a renewal rental rate which is less than a market rate, the fee owner sees some inflation protection and knows exactly how much the rent will be. Conversely, the Landlord may seek to set the fixed rentals higher to achieve what it hopes to be above a market rent as renewal is an option for the tenant and if the rent is too high, the tenant may hope that the landlord will negotiate a more equitable rent.

C. Use of Premises

Both the tenant and its leasehold mortgagee seek maximum flexibility as to the permitted uses by the tenant. Over a period of years the initially most desirable use of the property may change and any excessively limiting use restrictions may reduce its marketability. Provided the permitted uses are legal, the fee owner really doesn't care as it expects the rental obligation to be "net" and so long as the value and utility of the property isn't diminished, the fee owner does not really care. While converting to another legally permissible use will generally not bother the fee owner, the fee owner may be concerned about excessive restoration costs of any new legal use. This can be addressed in the surrender provision but the owner should make sure that it sees and approves the plans and specifications involved in any use conversion or other major altercation.

To increase flexibility of permitted uses, the landlord should agree to grant or join in easements, covenants, restrictions, reciprocal easement agreements, permits and applications that are reasonably necessary for the development and maximum utilization of the property. One area where this has been extremely important in terms of restaurant and other food and beverage purveyors is making sure that drive-in windows, an anomaly many years ago, are permitted under the use clause.

D. Premises Demised

The premises demised under the leaseback are everything that was sold. Otherwise, it does not constitute a true leaseback. If the property conveyed includes easements or rights of way, they should be demised under the leaseback but should remain owned by the fee owner. Permits and licenses should also remain with the fee owner as they should not be lost if the leaseback is terminated.

E. Rent

The rent under the leaseback has to be ascertainable and certain. Part of the attractiveness to a purchaser of the fee interest in a sale/leaseback transaction is the absolute and continuing right to receive predictable rent payments on a recurring basis, usually calculated and paid monthly. Frequently when offered for sale, the price for the fee interest is based upon a certain percentage return on the purchase price. The percentage return reflects market interest rates as well as the credit of the tenant. Rental adjustments during the term must be reasonable and limited. The rent generally cannot be increased by the Consumer Price Index or some other independent formula because in such instances it is impossible to know in advance what the rent will be. So too, rent payable to the fee owner generally will not have a percentage rent component based upon sales.

F. Net Rent Concerns

The fee owner will want the rent payable to be what is known as "triple net". In other words, all of the expenses of operation have to be borne solely by the tenant. This includes the obligation to pay all real property taxes and any other assessments levied upon the property, the cost of complying with all applicable legal requirements and instruments of record affecting the property. While the tenant will be obligated to pay all real estate taxes and assessments, the tenant should be permitted to institute and control certiorari proceedings to reduce the taxes and, to the extent required by law, the landlord should be obligated to join in such certiorari proceedings or should empower the tenant to do so in the landlord's name but all of the risk and expense must be upon the tenant. Towards the end of the lease term where a tenant may have lost interest in keeping the real estate taxes low, the landlord should be given a concurrent right to institute and prosecute certiorari proceedings. Questions often arise as to whether a leaseback is a "net lease" or a "triple net lease". Although there is not standard definition for such terms and such terms may be interpreted as being synonyms, the more prudent course is to use the term "triple net lease" and to explicitly state that the fee owner shall have no responsibility for paying costs of repair, alteration or replacement of improvements to the property to the effect that the rent shall be net to the fee owner. To the extent that questions may arise as whether there is a distinction between such terms, any dispute usually concerns whether the fee owner/landlord has responsibility for repair and replacement of the roof.
Improvements and Alterations:

The tenant under leasehold wants the ability to make alterations and improvements to the property. These should be allowed to the extent that they do not diminish the utility or value of the property. As stated above, when considering a tenant's request to make alterations, the landlord should consider the restoration costs if the alterations will not be generally usable by a succeeding tenant. Similarly, the tenant should not be permitted to change the use if such change would diminish, reduce or prohibit the then use of the property. This frequently happens in a situation where the then use is a "Pre-existing nonconforming use" which under then applicable local

zoning ordinances would be not permitted to continue were such use discontinued for a period of time, frequently a year.

More serious issues exist where the tenant seeks to demolish existing structures and construct a new building. Such rights are frequently granted in long-term leasebacks as uses and improvements may outlast their utility. In such instances, once the building has been taken down, the value of the leasehold is significantly reduced. In such a case, often the lease provides that the tenant is required to post a security deposit (whether in cash or by letter of credit) equal to the cost of rebuilding (often plus a cushion in the event of cost overruns). In such an instance the landlord would have the right to review and approve the plans and specifications of the replacement building to ensure that the value of the newly reconstructed building is sufficient. Often the security deposit may be posted with either the fee mortgagee or the leasehold mortgagee to whom the approval rights can also be delegated. once the new building is fully completed and occupied, the security deposit can be returned to the party posting it, less any amount that has been drawn to cover shortfalls. The requirements for approvals and security in the case of construction of a replacement building (or substantial reconstruction of an existing building) tend not to be dissimilar to requirements of a construction loan, especially since mortgagee consent is generally required. In many instances, rather than demolishing an existing building, the tenant may simply strip the existing building down to its core in order to preserve existing benefits (such as height which exceeds that permitted under then existing zoning requirements) which would be lost if the building were demolished.

G. Insurance/Damage/Condemnation

All parties want the property to be properly insured against damage by casualty and other insurable risks. The premiums for the insurance will be paid by the tenant under the leaseback however, both the fee mortgagee and the leasehold mortgage will set forth their own requirements as to the adequacy of coverage, the Best's rating of the insurance companies and other requirements as to adequacy of coverage. No one wants the "coinsurance" provisions to kick in as it is to everyone's benefit that the full insurable value of the improvements is covered, hopefully by obtaining "an agreed amount endorsement". Regardless of the requirements of the insurance policies, both mortgagees want a right to participate and control the adjustment of insurance proceeds in the event of a loss covered by insurance. While it sounds nice to allow the tenant to "self-insure", self-insurance is quite complicated and has many risks such that is not frequently utilized anymore. The mortgagees will want protection under "noncontributory mortgagee endorsements".

Equally important is that the tenant should have a rebuilding obligation and a very limited right (if at all) to cancel the lease in the event of a major casualty. The fee owner and the fee mortgagee will want assurance both that the proceeds of insurance will be permitted by the leasehold mortgagee to be applied to restoration and the rental obligation under the leaseback is not reduced or abated. Where there is no right of the tenant to cancel the lease regardless of the severity of the casualty loss, this is frequently referred to as "a hell or highwater lease".

Condemnation is somewhat more complicated. In the event of a total taking of the property by condemnation, the interest of both the landlord and the tenant will disappear. The key to an equitable condemnation provision is to set forth a negotiated formula to specifically and fairly allocate the condemnation award. The landlord/fee owner wants to receive the value of the land (considered to be unimproved but subject to the lease), which is essentially getting it the capitalized value of the rent at a market interest rate together with any residual interest in the land at the end of the lease term. As the lease term runs out, the landlord/fee owner's residual interest value increases.

The tenant wants to receive the value of the lease and the improvements while at the same time making sure that its leasehold mortgagee get sufficient funds to pay off the first leasehold mortgage. Indeed, the leasehold mortgagee, especially if it is an institutional lender and has made a loan based solely on the appraised value of the leasehold, wants to be first in line to receive funds to pay off the leasehold mortgage. Since institutional lenders have restrictions on how much they can lend in relation to the appraised value (as such loans are typically nonrecourse) letting a first institutional leasehold lender get paid off first is generally not a problem.

In the event of a partial taking, the lease continues, and the condemnation award is first applied to restoration even if only part of the building is taken with any excess allocated among the parties to provide for the landlord to get the portion of the award allocable to the land that is taken within the excess going to the tenant. In such an instance, there is a pro rata reduction in the rent payable which would be based upon the percentage of the land that is taken. Consideration should be given to the type of land taken. For example, if a number of parking spaces are taken and that affects the value of the balance of the improvements, consideration should be given to the diminution of each party's estate. At times a partial taking can be more problematic than a total taking, especially

if it reduces access or the number of permitted parking spaces below the number which makes the improvements viable or eliminates a “drive-through” option for a fast service takeout food vendor. Some warehouse uses, such as for an Amazon or FedEx distribution center are laid out inside as one continuous conveyor belt to the effect that a partial condemnation (or even a casualty which affects a portion of the improvements) will render the entire facility useless. Clearly, the condemnation clauses and casualty clauses for such uses have to be drafted with those issues in mind.

H. Defaults

When it comes to defaults, special consideration should be taken to protect the interests of a leasehold mortgagee. If a default results in a termination of the leaseback, the leasehold mortgagee’s security completely disappears. Accordingly, the parties must make sure that notice of any default is given by the landlord to the leasehold mortgagee. So too, all notices of any importance between the landlord and the tenant must similarly be given to the leasehold mortgagee. Since the leasehold mortgagee may well want to cure any default, the landlord should give the leasehold mortgagee additional time to cure any default, especially if it requires something more complicated than just paying money (i.e. performing repairs) since the leasehold mortgagee would first have to obtain possession of the property to effectuate the cure. Depending upon the jurisdiction where the property is located the mortgagee may be able to quickly obtain possession of the property in the event of a default or it may take a substantially longer period of time. Non-curable defaults should not result in the termination of the leaseback if the leasehold mortgagee is exercising remedies available to it in order to get possession and assume the position of the leasehold tenant.

I. Assignment and Subletting

The leaseback tenant requires maximum flexibility not only for its own benefit but also for that of any leasehold mortgagee. So long as the use is legal, essentially maximizes the value of the property and the property is maintained in good condition, the fee owner should not really care about the use other than for reasons discussed above about limiting future uses. Leasehold mortgagees feel the same way as the leaseback tenant because they would be in the same position as the tenant in the event that they foreclosed on their security. The fee owner/landlord should not impose any burdensome conditions to allow the tenant to assign the leaseback or to sublease all or part of the premises nor should the fee owner/landlord have discretion in granting such consents. If there arise a stalemate in negotiating the requirements for an assignee or subtenant, the issue can be resolved by having the assignor or sublessor post security (or additional security) with the fee owner/landlord. If there is no provision with regard to assignment, most states provide that the lease may be assigned without any restrictions. The leasehold mortgagee wants to make sure that the tenant’s interest in the leaseback can be assigned it to in the event it forecloses on its leasehold mortgage and it or its designee becomes the tenant under the leaseback it without any impediments.

Upon any assignment by the tenant, the tenant would want to be relieved of liability. The fee owner may not want to release any assigning tenant from liability, especially if the tenant was the prior owner and may have committed waste or something for which it could still have ongoing liability. However, most leases provide that upon and assignment, the assigning tenants get released. The ability to freely sublease all or parts of the premises will be very important for a leaseback tenant. One area which may be slightly more problematic is the obligation of the fee owner to give recognition agreements to subtenants. Such agreements provide that in the event that the leaseback tenant disappears by reason of default that the fee owner will recognize the subtenant as its direct tenant. Of course, this all depends upon the rent because if the fee owner has been getting more than the sublease rent, its willingness to recognize a subtenant as its direct tenant will be much more limited. Often the issue between the fee owner/landlord and the subtenant in determining whether to grant a subtenant in determining whether to grant a subtenant a recognition agreement will boil down to what the rent will be. The subtenant wants its rent to remain the same while the fee owner/landlord wants the subtenant to step up and pay the rent its tenant was paying since sublease rents are generally lower than direct rent obligations. However, leasebacks are different since the defaulting tenant is paying all of the operating expenses (which the subtenant now wants the fee owner/landlord to assume the obligations to perform) and pay even have paid for the building to have been constructed. Therefore, the sublease rent may be higher than the direct rent.

J. Environmental concerns

As with any leased property, environmental concerns can always end up being an issue for the parties. Sale-leasebacks are somewhat different because the tenant under the leaseback was the prior owner who either created it or should have known about environmental hazards on the property. The new fee owner wants absolutely

no responsibility for any environmental hazards (most likely a leaking underground storage tank). Therefore, every leaseback should contain a representation by the tenant that it is not aware of any environmental conditions which could give rise to liability under applicable law. In addition, the tenant should covenant to get rid of any toxic materials or environmental hazards. Since the new owner may be statutorily liable for any environmental hazards, the fee owner should get a full indemnity from the tenant which covers not only costs of remediation and the costs of removal but also any liability to government entities under applicable law and legal costs and expenses in defending any and all claims against the fee owner for environmental liabilities.

K. Leasehold Financing Concerns

Once the original owner has sold the property and leased it back, it will hopefully have garnered an excellent sales price for the property, bolstered by the leaseback tenant to pay rent as a credit tenant. In order to maximize the proceeds of the sale-leaseback transaction, the original owner may also want to finance its leasehold interest in the property so that its cash investment remaining in the property is relatively low and also to improve the property.

Interestingly, the fee owner as purchaser of the leaseback property should have relatively little difficulty financing its fee position because of the strong covenant to pay rent at agreed rental numbers. Therefore, it may well be able to obtain quality financing in an amount significantly more than would otherwise have been possible without a sale-leaseback. Not all lenders are familiar with or comfortable making leasehold loans, though. The major problem is that if the lease is terminated by reason of a default by the tenant, the leasehold lender's security has disappeared unless precautions are taken.

Over the years certain key provisions and concepts have been developed in order to protect the leasehold lender. Such protections include:

(1) Right to encumber leasehold. The express right to encumber the tenant's leasehold interest should be contained within the lease itself. A prohibition or restriction on financing the leasehold estate will severely limit the tenant's ability to maximize the amount of funds it can withdraw from the property. However, it is not unusual for a leasehold to contain a clause that limits the amount of the leasehold financing and restricts the permitted leasehold mortgage lenders to institutional lender. One exception is that purchase money financing should be allowed in such situations. If leasehold financing is permitted, the lender under the leasehold financing should have to give notice of the financing to the fee owner in addition to providing the fee owner with copies of all of the applicable loan documents. Since the leasehold mortgagee is relying upon the funds generated for the benefit of the leasehold, the tenant should be restricted from taking out multiple mortgages with conflicting provisions. A leasehold mortgage will often be restricted such that the maturity date of the leasehold mortgage will not extend beyond the expiration date of the lease.

(2) Approval of certain actions. The leasehold tenant should not be allowed to sublet, amend, modify, cancel or terminate the lease, without the approval of its lender.

(3) Leasehold mortgagee's right to receive notice of defaults and effectuate a cure.

i. Right to receive notice of default. In furtherance of a leasehold mortgagee's ongoing concern of preserving the leasehold estate, a leasehold mortgagee will often request to receive duplicate notice of all notices which are sent to the leasehold tenant by the fee owner, relating to the Ground Lease. [2] Additionally, a leasehold mortgagee may further request that no such notices are effective unless dually served to such leasehold mortgagee. While the leasehold mortgagee surely does not want to receive a copy of all transmissions between the fee owner and leasehold tenant (i.e. holiday cards and other immaterial correspondence), the leasehold mortgagee is ideally looking for notice of any material occurrence relating to the Ground Lease which currently is, or with the passage of time could lead to, adverse effects on the leasehold mortgagee's collateral. [3]

ii. Right to cure defaults. Not surprisingly, the reason for the leasehold mortgagee's requisite right to receive notice of defaults under a Ground Lease is so that such leasehold

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[2] Commercial Real Estate Leasing § 10:4 (2d ed.), Stuart M. Saft (July 2016 Update).

[3] Typically, a Ground Lease will require that a leasehold mortgagee provide (a) a written request to receive duplicate notices under the Ground Lease along with the address for such notices and (b) a conformed copy of the security instrument filed to secure the leasehold mortgage collateral in order to be eligible to receive copies of all notices.

mortgagee will be able to effectuate a cure and preserve the leasehold interest. Accordingly, a leasehold mortgagee will seek a provision in the Ground Lease (or ancillary agreement with the fee owner) which provides the leasehold mortgagee the right to "step into the shoes" of a defaulting leasehold tenant and to effectuate a cure of a default. [4]

For monetary defaults (i.e. defaults in the payment of rent), a leasehold mortgagee will typically be allotted the same amount of time as the leasehold tenant is granted under the lease in order to effectuate a cure. [5] However, in the event of nonmonetary defaults, effectuating a cure may be more difficult for a leasehold mortgagee, as possession of the leasehold estate may be required in order to cure the default. Accordingly, many fee owners will agree to permit a leasehold mortgagee adequate time to acquire or gain possession of the leasehold interest through foreclosure, assignment in lieu of foreclosure or other exercise of remedies in order to allow the leasehold mortgagee to cure the nonmonetary default. [6] The ability of a leasehold mortgagee to gain possession of the leasehold estate and effectuate a cure is crucial in mitigating the risk of losing the leasehold collateral for an event outside of the control of the leasehold mortgagee. [7] To the extent that a leasehold mortgagee gains possession of the leasehold estate and there is a nonmonetary default by the leasehold tenant which cannot reasonably be cured by such leasehold mortgagee (i.e. a bankruptcy of the leasehold tenant), then the leasehold mortgagee will often request that, provided the leasehold mortgagee is paying rent and performing all other obligations as tenant under the Ground Lease, the fee owner will waive all non-curable defaults.

(4) Participation in decision making. There are not all that many situations in a sale-leaseback transaction where there are decisions to be made. They come up most frequently when talking about settling insurance or condemnation claims, consenting to major alterations, or determining the rent for renewal terms. In all such situations, the leasehold mortgagee wants to have a voice because it can effect the value of the leasehold and affect the likelihood of repayment of the leasehold mortgage.

(5) Need for estoppel certificates. One area often overlooked by leasehold lender is the need for the tenant to be obligated to promptly execute and deliver estoppel certificates. In leases and loans, estoppel certificates are very important. They let a requesting third-party which could be the landlord if the one asked to give the estoppel certificate is the tenant and sometimes it the tenant if the one who is being asked to give the estoppel certificate is the landlord and sometimes they are addressed to potential purchasers or lenders.

The estoppel certificates confirm facts that are not ascertainable just by looking at the lease such as whether or not a default exists (which are often given "to the best of the knowledge" of the party signing the estoppel certificate), whether there have been amendments to the lease that the other party is not aware of and whether or not a security deposit is still in existence and had not been depleted. Other items which may be covered in an estoppel certificate are the dates to which rent has been paid, whether or not an option to renew has been exercised and whether there are outstanding notices of default. Estoppel certificates are very valuable because the one receiving the estoppel certificate is entitled to rely on it and the one giving the estoppel certificate is "estopped" from asserting facts different than those certified in the estoppel certificate.

In addition, frequently when preparing estoppel certificates or subordination non-disturbance and attornment agreements, lenders go further than the stated purpose of the requested agreement. They ask to get additional rights and additional time periods to cure tenant defaults beyond those set forth in the lease document itself.

(6) Merger of estates. The leasehold mortgagee wants to make sure that the lease contains a provision providing that in the event that the fee owner ends up also holding the tenant's interest under the leasehold, there shall be no merger of the two estates. This is because if the two estates merge, it becomes impossible for the leasehold mortgagee to get a new lease.

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[4] Commercial Real Estate Leasing § 10:4 (2d ed.), Stuart M. Saft (July 2016 Update).

[5] *Id.*

[6] *Id.*

[7] Older Ground Leases for extended terms may not contain a leasehold mortgagee cure provision, in which case, it is often necessary to either amend the Ground Lease to include this provision or to include this provision in an Agreement of Ground Lessor.

In the event that the leaseback does not contain all of the protective provisions that a leasehold mortgagee hopes to see, the leasehold mortgagee, the tenant and the fee owner can enter into an amendment of the leaseback to make sure that all bases are covered. Also, the leasehold mortgagee may want confirmation that the leaseback can be assigned to the lender without the consent of the fee owner or compliance with any other conditions. They may also wish to put some of those provisions in a tri-party estoppel certificate. The problem with putting them in a tri-party estoppel certificate is that estoppel certificates are often overlooked and generally are not in recordable form so it is hard to put third parties on notice as to its existence.

(7) Right to a new lease. One of the most important and most advanced leasehold mortgagee protections is the right to a new lease following the termination of the Ground Lease for *any reason*. [8] In the event of an adverse event under the Ground Lease which results in the termination of the Ground Lease as between the leasehold tenant and the fee owner, a leasehold mortgagee will seek to rescue its collateral by entering into a new, direct lease with the fee owner on the same terms and conditions which were set forth in the Ground Lease.

A leasehold mortgagee, even though it has cure rights, may for one reason or another be unable to effectuate a cure, and the catastrophic loss it would face from the divestment of the security interest is mitigated by a new lease provision. [9] Accordingly, a leasehold mortgagee will seek to have a Ground Lease (or ancillary agreement with the fee owner) include a new lease provision which covers all situations resulting in the extinguishment of the leasehold interest and minimizes the conditions or impediments to obtaining such a new lease.

To be inclusive of all possible extinguishments of the Ground Lease which may arise, a comprehensive new lease provision will provide that a leasehold mortgagee has the right to enter into a new lease with the fee owner upon the termination of the Ground Lease for any reason, expressly including the rejection or disaffirmation of the Ground Lease in a bankruptcy or other laws affecting creditor's rights. [10] As bankruptcy courts are unclear as to whether a termination is synonymous (legally) to a rejection or disaffirmation, a leasehold tenant filing for bankruptcy who rejects the Ground Lease in a bankruptcy could leave a void in the leasehold mortgagee's protective rights to obtain a new lease. [11] [12]

(8) Representations and warranties contained in the leasehold mortgage. Since the leasehold lender is essentially a stranger to the sale/leaseback transaction, it feels that it should to get certain representations and warranties from the tenant (coupled with an estoppel certificate from the new owner of the land) to ensure everything is as the lender had expected. These would include representations as to the due execution, delivery and enforceability of all operative documents and representations about the status of title.

III. Lease Subordination and Priority

In the context of leasehold financing, the fee owner often wishes to retain the right to mortgage its fee interest in the related property. The leasehold estate and fee estate are distinct legal entities, therefore the encumbrance of the fee estate is still possible even with the encumbrance of the leasehold interest. [13] The issue, however, lies in dealing with the priority of the two encumbrances.

Ideally, a Ground Lease will provide that the fee owner is prohibited, during the term of the Ground Lease, from mortgaging, encumbering or otherwise hypothecating its fee interest in the premises. However, often times the Ground Lease provides the exact opposite and expressly permits the interest of the fee owner to be encumbered by a fee mortgage (and fee owners regularly exercise this right).

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[8] Commercial Real Estate Leasing § 10:4 (2d ed.), Stuart M. Saft (July 2016 Update).
[9] The Top Two Ground Lease Financing Flaws: Deficient "New Lease" Clauses and Superior Fee Mortgages, Structured Finance Report (Moody's Global Credit Research), Jan. 6, 2016.
[10] *Id.*
[11] *Id.*
[12] Note that if the Ground Lease is rejected, but not terminated, there is a possibility the Ground Lease lies in purgatory without the legal ability for a leasehold mortgagee to reach it.
[13] The Top Two Ground Lease Financing Flaws: Deficient "New Lease" Clauses and Superior Fee Mortgages, Structured Finance Report (Moody's Global Credit Research), Jan. 6, 2016.

Typically, in a situation where a fee estate is encumbered by a fee mortgage, a fee mortgagee will require that the leasehold tenant enter into a Non-Disturbance Agreement ("NDA") or Subordination Non-Disturbance and Attornment Agreement ("SNDA"). Arguably upon the execution of an NDA or SNDA, since the fee mortgagee has granted non-disturbance to the leasehold tenant, a leasehold mortgagee should have no issue with the subordinate nature of the leasehold estate in relation to the fee mortgage because if the fee mortgage is foreclosed upon, the leasehold estate is protected by the non-disturbance clause in the SNDA or NDA. [14] However, because an SNDA or NDA is an executory contract which could be rejected in a bankruptcy of the fee mortgagee, the risk of the leasehold estate losing the non-disturbance which was purported to be granted by the SNDA causes "heartburn" for many leasehold mortgagees as the leasehold estate (in some instances) could be extinguished by a superior fee mortgagee in a foreclosure action, even though non-disturbance was granted. [15]

Additionally, Ground Leases which are subordinate to fee mortgages provide difficult questions as to what happens in certain circumstances between a fee mortgagee and leasehold mortgagee. If a Ground Lease is subordinate to a fee mortgage and a leasehold mortgagee holds a security interest in an subordinate leasehold estate, it may be unclear what happens in the event of a (a) casualty or condemnation[16] or (b) a leasehold tenant's option to purchase the underlying fee estate. [17] [18]

See attached for a sample checklist of leasehold mortgagee financing checklist as <u>Exhibit A</u>.

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[14] *Id.*

[15] The Top Two Ground Lease Financing Flaws: Deficient "New Lease" Clauses and Superior Fee Mortgages, Structured Finance Report (Moody's Global Credit Research), Jan. 6, 2016.

[16] The leasehold mortgagee would be concerned that the fee mortgage has made the lease subordinate to the terms and conditions of such mortgage, including the application of insurance proceeds and condemnation awards.

[17] If the leasehold tenant holds the option to purchase and elects to exercise its right, theoretically it must take fee title subject to a prior fee mortgage if the leasehold estate is subordinated to the fee mortgage and may be required to pay the difference between the mortgage and the purchase price.

[18] "It's All About the Money – Leases as Collateral for Mortgage Loans" ABA/ACREL 2016 Intermediate Financing Series 04/13/16 (Adam B. Weissburg, Barry A. Hines and Everett S. Ward) , also available in ACREL Program Materials Spring 2016, available at www.ali-cle.org<http://www.ali-cle.org/>>

EXHIBIT A
LEASEHOLD MORTGAGEE PROTECTION CHECKLIST

- ☐ Adequate Lease Term
    - ☐ Fully Amortizing Loan- Term is coterminous with maturity date of loan.
    - ☐ Non-Fully Amortizing Loan- Term extends significantly beyond maturity date of loan (20-30 yrs).
- ☐ Leasehold estate expressly permitted to be encumbered by leasehold mortgage.
- ☐ Lease may not be modified, amended, cancelled, terminated or surrendered without consent of leasehold mortgagee.
- ☐ Leasehold mortgagee is entitled to receive copy of all notices sent to leasehold tenant under the Ground Lease and no such notice is effective unless dually served to such leasehold mortgagee.
- ☐ Leasehold mortgagee has the right to cure all defaults of leasehold tenant and has the right to extend any applicable cure period for such time as necessary in order to acquire the leasehold estate, if such acquisition is required to effectuate a cure.
    - ☐ Fee owner shall waive all non-curable defaults following a leasehold mortgagee's acquisition of leasehold title.
- ☐ Ground Lease assignable to leasehold mortgagee upon foreclosure/assignment in lieu of foreclosure without fee owner consent (and further assignable thereafter without consent).
    - ☐ Leasehold mortgagee entitled to exercise all rights of leasehold tenant following acquisition.
- ☐ Casualty proceeds are held and applied in accordance with the terms of the leasehold mortgage loan documents.
- ☐ Fee and leasehold estate each entitled to their own condemnation awards and condemnation awards attributable to the leasehold estate are held and applied in accordance with the terms of the leasehold mortgage loan documents.
- ☐ Leasehold mortgagee entitled to new lease upon termination of the Ground Lease <u>for any reason</u> expressly including rejection of the Ground Lease in a bankruptcy or pursuant to any other law affecting creditor's rights. The new lease shall be of equal priority as the lease prior to its termination, rejection or disaffirmation.
- ☐ Fee estate to remain unencumbered during the term of the Ground Lease, or fee mortgage cannot be superior to the leasehold estate.
- ☐ No merger of the fee and leasehold interests if ever held under common ownership.
- ☐ Leasehold tenant has the right to freely sublet the leasehold premises.
- ☐ Fee owner agrees to provide an estoppel to future leasehold mortgagees.
- ☐ There are no current events of default under the Ground Lease.
- ☐ The fee owner has no preferential rights of first refusal or options to purchase which could prime a leasehold mortgagee's rights.
- ☐ The fee owner has agreed not to disturb the quiet enjoyment of the leasehold tenant.