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Workshop 3

Financeability of Your Lease: What Lenders Really Want to See in Leases--Taking the Guesswork out of Making Your Lender Happy

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Leasehold lending (i.e. a loan secured by a lien on a tenant's leasehold interest in property) can be a particularly challenging form of real estate lending as the lender's collateral is more ephemeral than a traditional real estate loan. Because of these additional risks some lenders simply will not make leasehold loans. Lenders who are amenable to leasehold lending will conduct a thorough review of the proposed lease and expect for the lease to contain a number of lender protections to limit this risk. This paper summarizes some of the most material provisions lenders will expect to see in order for a lease to be "financeable".

In these materials, we often refer to the subject lease as a "ground lease"; however, other types of long-term leases may also be acceptable collateral for a leasehold loan and these materials are equally applicable to other types of leases for which tenant is proposing to obtain financing.

There may be additional statutory requirements applicable to certain types of lenders in certain states. Such statutory requirements are beyond the scope of these materials, but lenders and tenants should be aware that there may be additional state-specific requirements with which leasehold lenders may need to comply.

I. Tenant's Right to Encumber its Leasehold Interest

The ground lease should provide for certain protections for the leasehold lender, including the tenant's right to mortgage and assign the lease to those meeting certain requirements without the landlord's consent. Many ground leases include a definition of what constitutes a permissible leasehold lender. The tenant should ensure this definition is broad enough to include the proposed leasehold lender. If there is any ambiguity as to whether the leasehold lender is an approved lender under the ground lease, the landlord should confirm in the ground lessor estoppel that the leasehold lender and mortgage are approved.

II. Current Lease Term and Timing for Exercising Extension Options

A. Length of Lease Term

At its most basic level, the term of the lease cannot lapse prior to the maturity date of the mortgage; however, most leasehold lenders will look for the lease term to be sufficient to allow lender to recoup its outstanding loan balance and interest following a foreclosure of the leasehold mortgage either through operation of the property or a sale of the leasehold interest. Ideally, the least term would extend for a period of at least ten (10) years past the maturity date.

B. Exercising Extension Options in Advance

If the initial term is not sufficient to meet the criteria stated above, a lender may consider including extension options in the calculation. If extension options will be included in lender's calculation of a sufficient term, the options must be exercisable well in advance of the expiration of the current term and cannot include any level of landlord approval or discretion. Ideally, any required extension options should be exercised at the time the loan closes, however this may not be possible in all circumstances. Landlord's interest should be aligned with the lender on this point as an early exercise of extension rights creates additional stability for the landlord.

Potential Fallback: If the lease doesn't allow for early exercise of extension options and landlord won't agree to an exception, lender can require that borrower deposit an undated exercise notice in escrow so that lender can exercise the extension option at the appropriate time even if borrower fails to do so.

C. Lender's Unilateral Right to Exercise

Ideally, the lease would acknowledge that the lender may exercise an extension option on behalf of the tenant and that an extension notice from lender would have the same force and effect as a notice from the tenant.

Potential Fallback: If landlord will not agree to allow lender to exercise an extension option the tenant's behalf, lender can require that borrower deposit an undated exercise notice in escrow so that lender can exercise the extension option at the appropriate time even if borrower fails to do so.

III. Casualty & Condemnation

In a typical ground lease, the tenant owns the improvements throughout the term of the lease with any improvements reverting to the landlord at the end of the lease term. Since the tenant's interest in the improvements

are part of the collateral for the leasehold loan, leasehold lender should be listed as the loss payee under tenant's property insurance.

A. Lender Participation

If there is damage to the premises resulting from a fire or other casualty or if there is a condemnation proceeding initiated against the premises, the leasehold lender must be notified and have the right to participate in any adjustment of insurance proceeds or compensation for a taking. Any settlement should be subject to the approval of the leasehold lender.

B. Administration of Proceeds

If there is both a fee mortgage and a leasehold mortgage, the ground lease must establish a formula for allocation of any casualty or condemnation proceeds between the fee mortgagee, leasehold lender, landlord and tenant. The formula can be quite complicated; however, the majority of the proceeds should be allocated to the leasehold lender. The proceeds should be held by a third party trustee or by the leasehold lender to be disbursed and utilized for the restoration of the damaged premises under reasonable inspection and disbursement procedures similar to the proceeds applicable to a construction loan.

C. Application of Proceeds to the Loan

Loan documents typically give the lender the right to determine whether proceeds should be used to restore the premises or applied to the outstanding balance of the loan. The lease should similarly reflect this right; however, landlords may object to this right as they are anticipating ownership of the improvements at the end of the lease term and likely set the rental rate in the lease anticipating the increased value to their property at the end of the lease term. If the ground lease allows for termination of the lease following a material casualty or condemnation, the lease must provide that proceeds will be used first to pay off the outstanding balance of the leasehold loan.

IV. Lender's Right to Cure

The lease should require that landlord send copies of any default notices under the lease simultaneously to lender and provide that no default notice is effective unless it is also sent to lender. The lease should confirm that the landlord will accept performance or cure by lender and the same will have the same effect as performance or cure by the tenant.

A. Additional Time to Cure

The leasehold lender should have additional time beyond the tenant cure periods in the lease to cure both monetary and non-monetary tenant defaults. Typically, the lender will want to wait to see if the tenant is going to cure before deciding to step in and cure a tenant default to prevent the landlord from exercising its remedies. It is not reasonable for the landlord to expect the lender to cure within the original cure period granted to the tenant under the lease – lender should not be viewed as a guarantor of the tenant's obligations. A deadline for curing monetary defaults is typically acceptable (30 days is typical), but most lenders prefer to avoid deadlines for curing non-monetary defaults as long as they are diligently pursuing the cure.

B. Cures that Require Possession/Control

Cure periods for non-monetary defaults that would require lender to obtain possession or control of the premises should not begin to run until lender obtains the required possession or control, provided lender cures any monetary defaults and diligently pursues possession of the premises.

C. Waiver of Defaults that Cannot be Cured

The lease should provide that any defaults that cannot be cured by lender (i.e. a tenant bankruptcy, failure to deliver financial statements, etc.) will be waived upon lender succeeding to the tenant's interest in the lease.

Potential Fallback: If landlord will not agree to include such a provision in the lease, it could be addressed in a separate estoppel or recognition agreement. Although not ideal from the lender perspective, this allows the landlord to limit the waiver just to the current leasehold lender.

D. Lender Right to a New Lease

If the lease is terminated as a result of a tenant default, the lease should provide that landlord will enter into a new lease with lender or its nominee on substantially the same terms as the original lease. Lender's concern is that a default notice may be overlooked and lender may miss its opportunity to cure. Lender's will typically agree to pay any delinquent rent not paid by the borrower and to pay landlord's expenses incurred in evicting the tenant in connection with the execution of the new lease. If there are subleases under the ground lease, landlord also must agree to assign these to lender (since they would have reverted to direct leases with the landlord upon the termination of the ground lease).

Although most leasehold lender insist on this provision, leasehold lenders should be aware of some potential issues with these provisions:

1. Since the new lease is an executory contract, the trustee in a landlord bankruptcy could seek to have it disaffirmed.
2. The right to a new lease may violate the rule against perpetuities (in states where this rule has not been abolished) due to the possible remoteness in vesting.
3. This right could interfere with tenant exercising its right of redemption to the extent commercial tenants have such a right.

One possible means of mitigating these issues is to require the landlord to execute a "back-up" lease with lender at the time of closing the leasehold loan. A back-up lease is presumably more likely to be enforceable since lender is committing to lease the property upon an early termination of the original lease; however, enforceability could still be an issue of landlord files for bankruptcy prior to lender taking possession of the premises.

V. Landlord Consent to Assignment and/or Subletting

Ideally, the tenant under a ground lease has the right to freely assign a ground lease or sublet the premises; however, many landlords want to retain some control over the tenant of their property. If the lease is not freely assignable, then the lease should expressly pre-approve certain transfers resulting from leasehold lender's exercise of its rights under the loan documents.

A. Transfer to Lender or Nominee; Subsequent Transfers

An assignment or other transfer to the lender or its nominee in connection with a foreclosure or deed in lieu of foreclosure should not require landlord's consent. An assignment to a third party as a result of a foreclosure sale also should not require landlord consent.

B. Subsequent Transfers

Most leasehold lenders will also require preapproval of an assignment from lender or its nominee to a third party as lenders are not in the business of owning and operating real estate and most likely will attempt to recoup their losses by selling the leasehold interest to a third party following a foreclosure or deed in lieu of foreclosure.

VI. Bankruptcy

If a landlord or tenant files for bankruptcy, the debtor or the bankruptcy trustee may reject or disaffirm the ground lease, thereby destroying lender's collateral. In either scenario, lender should have the right to step into the shoes of the tenant in directing the disposition of the lease. Most of these rights are typically addressed in the leasehold loan documents, rather than the ground lease, so we have not explored these considerations in detail in these materials. The ground lease should allow lender to require a new lease if the lease is rejected as part of a tenant bankruptcy; however, note the potential concerns with this approach described in Section IV above.

VII. Permitted Use

Tenants and leasehold lenders are aligned in seeking the most flexibility for the use of the premises during the lease term. A financeable lease should state that the premises may be used for any purpose permitted by applicable law. If the premises is located within a shopping center or larger development, it may be subject to certain prohibited or exclusive uses, but the lease should not require that the premises be operated for a particular purpose or under a specific trade name. The lease also should not include any ongoing operating covenant.

VIII. Lender Approval of Amendments and Terminations

Lender's consent should be a condition precedent to any amendment, cancellation, termination or surrender of the lease. Although this can be partially addressed by covenants in the leasehold loan documents, most lenders require that the landlord also agree to these provisions in the lease so lender has recourse against both parties if the covenants are violated.

IX. Notices to Lender

Any notices given by landlord to tenant under the ground lease should be sent simultaneously to the lender and notices of default should not be effective unless a copy is also sent to lender. The ground lessor estoppel should require landlord's acknowledgement of leasehold lender's address for such notices.

X. Fee Mortgages

The lease must be first in priority and should **not** be subordinate to any mortgage encumbering the fee interest in the property; the lease must expressly state that it will not be subordinate to any fee mortgage. This can seem counterintuitive to landlord and/or fee lenders who do not regularly encounter ground leases; however, it is a fundamental protection for a leasehold lender since the leasehold lender cannot risk the lease (its collateral) being terminated as part of a foreclosure of the fee mortgage.

Although a fee lender may point out that its "standard" SNDA includes non-disturbance provisions, these provisions simply do not give a leasehold lender sufficient comfort as most SNDAs provide that the fee lender can terminate the lease if the tenant is default at the time of the foreclosure.

If the fee is already encumbered by a mortgage prior to the ground lease, the fee lender must agree to subordinate its mortgage to the ground lease.

XI. Recordation

Lenders' preference would be that the complete ground lease be recorded so that all provisions are of record, including the standard mortgagee protections, and available to future successor landlords, tenants and lender. However, landlord and tenant may be reluctant to make the whole lease public, particularly the financial terms. If a memorandum of lease is recorded, it should contain more detail than a typical memorandum of lease and should include the standard mortgagee protections.

XII. Special Considerations for Existing Leases

A. Confirmation of Chain of Title (Landlord and Tenant)

Any assignments of the landlord's or tenant's interest in a ground lease should be recorded and lender should require copies of all such assignments so that it can confirm (i) that its borrower is the valid owner of the leasehold interest and (ii) that the party signing the ground lessor estoppel is the current holder of the fee interest in the premises.

B. Definition of Leased Premises

The description of the leased premises should be clearly ascertainable from the ground lease. A street address is not typically sufficient – lenders will expect a legal description of the premises to be attached to the lease.

C. Complete Lease File

Lenders will require a copy of the complete lease file, including any amendments, commencement date agreements and letter agreements altering the terms of the lease. The ground lessor estoppel should

include a full list of the lease documents and a representation from the landlord that the documents listed are all of the documents comprising the ground lease.

D. Updating a Deficient Lease

If an existing ground lease does not meet the leasehold lender's minimum criteria for financeability, the ground lease will need to be amended prior to the closing of the loan. Some landlords may object to signing an amendment to the existing lease because they do not want to be bound by those modifications in a future tenant financing. Although a formal amendment is the preferred route, a leasehold lender may be willing to accept a ground lessor estoppel that includes landlord's agreement to certain modification to the lease. From a landlord's perspective, this has the benefit of not binding the landlord to agree to the same leasehold lender protections on future financing transactions. If a fee lender is also involved, consider whether the fee lender's consent would also be required for the modifications being made via the ground lessor estoppel.