CHAPTER TWENTY

HOW A LENDER LOOKS AT A LEASE

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I. WHY LENDERS CARE ABOUT LEASES

Leases in place are usually the major source of value for commercial real estate. For that reason, a mortgage lender typically wants to understand the space leases that affect—and are a crucial part of—the proposed real property collateral.[1]

When a mortgage lender begins to prepare for a commercial mortgage loan closing, the lender will often ask its counsel to review some or all of the leases. That review will focus on a handful of lender concerns driven by the lender's basic assumptions and desires about the leases. Those concerns are:

- *Confirmation of Income.* Do the leases support and substantiate the rent roll that the lender reviewed in estimating the value of the mortgaged property? Does the rent roll accurately describe the tenant's obligations to contribute to operating expenses and real estate taxes of the property?
- *Constancy of Cash Flow.* Does anything in the leases create a risk (or at least an unusual risk) of any interruption of cash flow to the borrower (and hence loan payments)?
- *Continuation of Leases.* Are the leases likely to stay in place, so that the value the lender saw in them will likely continue over the term of the loan and even after a possible foreclosure?
- *Concerns of a Landlord.* Recognizing that any mortgage lender is a landlord-in-waiting (or a possible seller of the property to a future investor), do the leases contain anything that a typical landlord would find unacceptable? Do they impose any unusual or unmeasurable obligations on the landlord?

1 This chapter considers only "space leases," which are leases from the borrower as landlord to actual users of the real property for occupancy. These leases produce income to the owner of the real property. In contrast, a "ground lease" runs from a third-party owner of the real property to a developer or investor that pays rent and often grants a mortgage on its rights under the ground lease to secure a loan. The negotiation and structuring of such a lease is more a financing transaction than a leasing transaction, and is outside the scope of this book. For more on ground leases, see Joshua Stein, "Model Leasehold Mortgagee Protections," *The American College of Real Estate Lawyers Papers*, October 1999; updated and republished for Chicago Title Insurance Company continuing legal education program (October 2000), Association of the Bar of the City of New York (November 2000), New York State Bar Association (October & November 2000); New York State Bar Association, Real Property Law Section, *Advanced Real Estate Practice*, December 2000; and New York Mortgage Bankers Association (September 2001). *See also* Joshua Stein, "How Much Protection Does a Leasehold Mortgagee Need?," *The Real Estate Finance Journal*, Spring 2003, at 5; "Alternatives to Site Acquisition—Ground Leases: An Overview," *Multi-Family Executive/Office & Industrial Properties*, June 2000.

The level of lease review that a lender requires for any particular loan transaction will depend on the circumstances. As with most other issues that arise in commercial mortgage loan closings, very much depends on the ratio between the loan amount and the value of the property. A lower loan-to-value ratio makes it easier for a lender to cut any number of corners. If a transaction is "stressed" from the beginning because of a high loan-to-value ratio, the lender and its counsel must approach leases—and everything else—that much more carefully.

As an equally fundamental question, the lender needs to decide and advise counsel whether the lender plans to rely on the particular leases presently in place, or whether the lender looks more generically to present and future rental income of the building generally—the rental value of the space whether occupied by today's tenants or by whatever replacement tenants the borrower might be able to find in the future.

Today's commercial mortgage lenders usually care much more about actual rental income from leases in place than about hypothetical future rental income. (The latter approach might be called a "Wild-Eighties" style of loan underwriting. Though it was common in the lending boom of the late Eighties, it helped contribute to the foreclosure boom that followed.)

Although any lender recognizes that today's leases will expire, and today's tenants may simply move out, a lender will also know that any effort to replace those tenants will take time and cost money, and even then may not replace the cash flow in place. If a property has significant short-term risk related to finding new tenants, a lender will regard the project as being not entirely stabilized, and will reassess its risk, and perhaps restructure the loan, accordingly.[2]

The more important any particular lease is, the more carefully lender's counsel needs to review it. "Anchor leases" (or large office leases) in particular will commonly require more careful review.

On the other hand, to the extent that the existing leases are below market or in default, or to the extent that the existing tenants are not creditworthy and likely to vanish, the lender may be more concerned about hypothetical future rental value (on the assumption the space will soon need to be re-let) than about the details of the existing leases. Even then, the lender may want its counsel to look for anything in an existing lease that a lender or a landlord would regard as completely unacceptable.

2 For a description of how a lender might view such a "redevelopment" project and restructure the loan, see Joshua Stein, "Retail Redevelopment Projects," *Real Estate Review*, Summer 1999, at 16.

A lender's instructions to its counsel regarding lease review will also vary depending on whether the lender: (a) obtains meaningful representations and warranties about the leases, backed by credit beyond the borrowing entity; and (b) trusts the borrower's competence in negotiating leases and operating the property.

The following outline describes the items that a lender will usually want its counsel to consider in any lease review project. Because of the wide variety of issues addressed in any lease, many of which are important under one particular circumstance or another (or they wouldn't be in the lease), it is always easy to find items to add to this list. Any lease review project can be expanded, almost without limit, if a lender decides it wants to be as exhaustive as possible. Nevertheless, this list should cover the major "hot buttons" of a mortgage lender in most transactions. Different lenders will, however, have different expectations for lease reviews in different transactions. Any lender's expectations will be completely different—and this list will be inadequate—for any "credit tenant lease," bondable lease, synthetic lease, or ground lease.

The discussion begins by describing, in Section II, some questions that need to be answered before a lease review project begins, to define its scope and exactly what the lender wants its counsel to deliver.

Once counsel begins the lease review process, that process might identify problems and issues in the leases. Section III briefly discusses what counsel should do when those problems or issues arise, and how they tie to the loan closing process more generally.

Section IV provides an overview of the basic general and financial questions that counsel should try to answer in any lease review, or questions whose answers counsel should confirm against the rent roll.

Section V then turns to a broader group of issues of a less directly economic nature—issues where a lender's concerns are about the same as those of any other potential owner of the mortgaged property, and therefore the lender's and the borrower's interests are fairly well aligned.

Finally, Section VI examines some issues that a lender will care about, but in which a landlord will probably have no direct interest. These issues relate to protecting the lender's interests at times when the lender does not (yet) own the mortgaged property.

The Lender's Lease Review form provided in Chapter 25 applies much of the advice contained in this chapter, and gives any lender's counsel a useful template for a lease review that follows the principles suggested in this chapter.

Although this chapter addresses lease review in the context of a mortgage loan closing, any landlord and its counsel should keep these concerns in mind when negotiating and preparing any new lease, to try to ensure that a lender will have no basis to object to that lease once it has been signed. The concerns described here will also guide any lease review undertaken for the purchaser of commercial real estate.

II. SOME PRELIMINARY QUESTIONS: DEFINING THE LEASE REVIEW

When lender's counsel begins to think about the leases for a new mortgage loan transaction, he or she needs to ask some preliminary questions that help define the job to be done, even before actually reading the first word of any lease.

A. What Lease?

Leases are often amended. If amended more than three or four times, they readily become a confusing mess because of sloppiness and imprecision in drafting.[3] Moreover, some amendments won't necessarily be called amendments, such as letter agreements that confirmed the exercise of an option and added to the space under the lease. If a lease has been extensively amended, it may make more sense to start by reading the most recent amendment first, as the more recent amendments will often amend and re-state the most important financial terms of the lease. In an extreme case, counsel may want the borrower to agree to try to amend and re-state the entire lease after the deal has closed, to mitigate the risk of issues, inconsistencies, and uncertainty resulting from the messiness and complexity of the lease document.

As the first step in any lease review, counsel should try to confirm that the borrower has delivered not only the lease, but also every amendment that affects it. Any lease review should indicate exactly which amendments counsel received. This is true even if the lender has requested only the most minimal and abbreviated lease review memorandum.

3 *See* Joshua Stein, A Practical Guide to Real Estate Practice, "How to Amend Transactional Documents" (2001).

Amendments will tend to address important issues and should be fully reflected in any lease review.

B. Missing Documents

If documents appear to be missing (which usually happens, particularly as a result of disguised amendments as mentioned above), request copies from the borrower or notify the client immediately. As a common example, if the lease gives the tenant options that the borrower treats as having been exercised, ask for some written confirmation of the exercise—at least the notice of exercise and ideally a letter agreement confirming the exercise and whatever economic adjustments resulted from it. (Absent such documentation, any uncertainty can usually be eliminated through an estoppel certificate, as described in Chapter 21.)

C. What Deliverable?

Counsel should understand exactly what form of "lease review" the lender wants for the particular transaction. At one extreme, the lender may want formal "abstracts" of each lease, a summary of the business terms and of any special "lender issues" the lease might create. Such abstracts often take more time than they are worth, thereby creating billing issues. Summaries or charts, even handwritten, may suffice. Clients that desire to control costs often request instead an extremely abbreviated memorandum that summarizes only "bullet points" of concern regarding the lease, not a complete abstract of every lease. Such a memorandum can be informal and need not use complete sentences. Sometimes, the right "deliverable" is nothing at all, beyond a confirmation that the leases reviewed seemed generally consistent with the rent roll, and nothing jumped out as being troublesome. In such a case, counsel should think about what happens if counsel's confirmation turns out to be wrong. Did counsel clearly indicate the scope of the lease review conducted? If so, is that enough to protect counsel from blame or even liability? Should counsel advise the lender of the risks of conducting a less-than-complete lease review?

In any event, the subject of "deliverables" is one that the lender and its counsel should resolve before the lease review begins and, in any case, before counsel responds to any request for an estimate of the legal fees for the closing. Large and open-ended lease review projects are perhaps one of the most common causes of billing problems and surprises in commercial mortgage loan closings.

The following are some further thoughts on techniques to control the lease review process:

- *Existing Abstracts.* If the borrower has already prepared abstracts of the leases, the lender may be willing to rely on them, particularly if competent counsel prepared them and lender's counsel can spot-check them.

- *Shared Abstracts.* Borrower and lender can engage a single law firm or due diligence contractor to prepare lease abstracts, taking into account the directions of both borrower and lender.

- *Marked Copies.* A borrower might have, or easily be able to prepare, copies of its leases marked to show changes from its standard form of lease. Such copies would allow lender's counsel to focus on deviations from the standard form rather than potentially considering every paragraph of every lease. (Occasionally, property owners prepare their execution leases in a way that highlights deviations from the standard form, just as a marked copy of the lease might.)

- *Compromise on Presentation.* Instead of requiring beautifully word-processed abstracts, the lender might settle for lease review forms, filled in by hand and not thereafter edited or reformatted.

- *Prepare Directly on Computer.* In the author's experience, lease abstracts take a fraction of the time and turn out better if the lease review form is set up in machine-readable form to be very easy to fill out on a computer. Then whoever reads the lease types the abstract by filling in the lease review form on the computer as he or she goes through the lease. Although the process might take a bit longer in the first instance (and make slightly more noise) than filling out a very simple paper form by hand, it requires almost no proofreading or further processing.

III. DEALING WITH PROBLEMS

The lease review process is intended to identify any problems or issues that might exist in the leases. Once those issues are identified, some of them may be major enough that they would lead the lender not to close the transaction. Others may lead the lender to establish reserves or other measures to mitigate whatever risks the lease review process identifies. In other words, the lease review process does not occur in a vacuum but as part of the process of structuring and closing the larger transaction. For that reason, coun-

sel should keep the following points in mind when undertaking any lease review process:

- *Problems and Exceptions.* Although the lease review process must in part confirm that the leases support the rent roll, counsel should try to focus on exceptions and problems, and act on them once found.

- *Assumptions.* Don't assume that the leases are "right." To the contrary, assume that they conceal mistakes and surprises, or at least might conceal mistakes and surprises. That's the whole purpose of the exercise.

- *Early Identification.* Try to identify any problems as early as possible in the process. They may require lease amendments or other cooperation by the tenant, all of which will take time. Because the importance of any problem will usually multiply for a larger or more important lease, start reviewing those leases first.

- *Remedies.* Any analysis of a problem in a lease is not complete without taking a look at the rights and remedies the lease creates if an issue ever arises. For example, a lease might grant a tenant an "exclusive" right to sell a particular type of product in its space. But the lease may also say that if the landlord violates the "exclusive," the tenant's only right is to claim a nominal and meaningless credit against rent. The limited nature of the tenant's remedy would probably make any lender less concerned about the "exclusive" clause. More generally, whenever any problem shows up in a lease, counsel also needs to focus on the parties' rights and remedies in the context of that particular problem.

- *Sounding the Alarm.* To the extent that a lease review discloses discrepancies or concerns, those should be noted—and reported to the client—in a way that brings them to the client's attention quickly, and not as part of a voluminous report about the leases as whole, most of which will be of no particular concern to the lender. Merely writing a little note somewhere, which someone else will have to notice, read, and think about, doesn't necessarily do the job.

In general, if the lender's counsel discovers a problem with a lease, the lender will usually have only four choices, some of which may lead to changes in the loan documentation:

- *Do Nothing.* In most cases, the lender will decide to live with the problem and whatever risk it creates. If the risk later "hits," counsel will sim-

ply want to be able to demonstrate that he or she identified the problem and fully disclosed it to the lender.

- *No Loan.* Decline to make the loan. Although lenders sometimes choose this option, it can damage relationships and sometimes lead to liability (or at least threats of liability), if the documentation to date does not give the lender adequate escape hatches. Lenders also sometimes use the possibility of not closing the loan as a mechanism to encourage borrowers to go solve the problem some other way.

- *Mitigate the Risk.* Figure out a way to mitigate the problem and whatever risk it creates (such as establishing a reserve or tailoring additional documents to give the lender additional controls or protections based on the circumstances).

- *Borrower Fix.* In rare cases, the borrower will be able to "fix" the problem. When this option is available, it will usually be the lender's first choice.

To the extent that the lender and borrower agree upon measures to solve a problem in a lease, the lender will also usually want to satisfy itself that those measures will work not only for today's loan closing, but also for any future loan closing. If a lease lacks some provision that the lender's counsel regards as important, the borrower might suggest a mechanism that gets past the problem for today's closing but will not necessarily help for the closing that will be necessary to refinance today's loan. For example, the tenant might issue a letter to the current lender that solves the problem, but the letter might not also benefit the next lender. In that case, although today's lender may be able to proceed with today's loan, it may also look ahead and be concerned about a future refinancing, and insist that the borrower develop a longer-term solution to the problem.

IV. GENERAL AND FINANCIAL QUESTIONS

The following is a more specific checklist of the basic points that matter when counsel reviews a lease to confirm its basic financial terms. In each case, the lender's counsel should check these points against the rent roll. To the extent that any of these items is inconsistent with the rent roll, the lender's counsel should note that inconsistency in the lease summary—whether it is "good" inconsistency (the facts are better than the rent roll suggests) or "bad" inconsistency (the opposite). Either type of inconsistency may affect the lender's decision process or even the ultimate business terms of the loan.

A. Tenant

In its zeal to uncover hidden issues or problems in a lease, a lender's counsel should not lose sight of a dumb basic issue that should jump out from any lease at anyone who is paying attention: Exactly which party is the tenant under the lease? If the lender assumes the tenant is a creditworthy chain or other large company, is that creditworthy entity the tenant? Or is the tenant some less creditworthy affiliate? Discrepancies and differences in the tenant's name may not be obvious, but catching them is perhaps the most important issue—as well as the easiest issue to explain and the easiest one to miss—in any lease review project.

B. Space

The lease should identify the address of the building, the leased premises within the building, and (sometimes) the size of the leased premises.

C. Term

When does the lease expire and what extension options does it give the tenant? Flag the existence of any expired lease or informal month-to-month extensions, as these potentially impair reliability of income. Does the file suggest any ambiguity, uncertainty, or dispute about whether a tenant in fact exercised an option and, if so, how that affected the rent or the tenant's other obligations under the lease? To the extent that the tenant has renewal options, must the tenant makes its decision far enough in advance to give the landlord enough time to re-rent the premises without risk of an interruption in rent?

D. Rent

Check the tenant's main rent obligations, which will typically consist of some combination of the following: (a) fixed or base rent, payable based on a schedule (usually monthly) in the lease; plus (b) escalations, whereby the tenant contributes to (i.e., protects the landlord and lender from increases in) real estate taxes, operating expenses, or other expenses of the building; or sometimes (c) percentage rent, a percentage of the tenant's gross sales.

E. Security Deposit

How much of a security deposit did the tenant provide? Watch out particularly for any form of security deposit other than cash, such as a letter of

credit.[4] If these security deposits are substantial, the lender may want to hold—or at least control—them, particularly if the lender requires a lockbox or other cash-management measures for the mortgaged property. The measures to allow a lender to take control of unusual security deposits may require attention early in the closing process, particularly to the extent that they may require cooperation from third parties (usually the tenant or a bank or other financial institution).

F. Construction Obligations

If the building is still under construction, or if the lease for some other reason was signed only recently, it may still obligate the landlord or tenant to complete or pay for certain construction to prepare the space for the tenant's business. Any such obligations will typically concern a lender, because they introduce construction-related risks that should not arise for a fully stabilized building. Lender's counsel will want to give its client answers to at least the following questions:

- *Landlord's Obligations.* What construction work must the landlord still perform, whether in the premises or in the common areas or elsewhere? Are these obligations clearly defined?

- *Remedies for Late Delivery.* If the landlord does not finish its construction on time, what can the tenant do? Can the tenant claim a rent credit? Can the tenant terminate the lease? May the tenant perform the work itself and offset rent?

- *Monetary Obligations.* If the landlord has agreed to make a cash contribution to the tenant's construction work, how much is that contribution and what conditions must the tenant satisfy in order to receive it?

- *Tenant's Remaining Work.* How much work does the lease indicate the tenant will perform? Is there anything about the work that makes it appear uncertain or difficult? Must the landlord participate in the tenant's work in ways that may turn out to be expensive or complicated?

V. LANDLORD'S LEASE ISSUES

Beyond the basic economic issues listed above, a lease raises a wide range of issues about the relationship between landlord and tenant. For most of those issues, the lender's concerns are quite similar to those of any land-

4 Letters of credit are discussed in Chapter 27. Chapter 28 focuses specifically on how a mortgage lender might respond to a letter of credit used in place of a security deposit.

lord. A lender will, however, often be more sensitive and concerned—particularly about any issue that might interfere with the reliability of cash flow—based on the lender's more "downside" orientation.

A borrower may, for example, be willing to tolerate some small risk of an impairment of rental income if that is the price of "getting the lease" or if the borrower regards the risk as immaterial in the context of the "big picture." In making that decision, the borrower has probably identified both the "downside" and "upside" in the project as a whole, and is willing to live with the former as the price of the latter. A lender attaches less weight to the possible "upside" and cares more about preventing the "downside," hence it will weigh risks differently from a borrower and care about small risks that the borrower won't. A borrower will also be more likely than a lender to believe that it can control or mitigate any risk that the lease creates, whereas the lender may see only risk.

Because a routine space lease can potentially deal with hundreds of issues,[5] the range of possible concerns to a lender is almost limitless. A lender could, if it wished, have its counsel review any lease—or selected leases in a building—with the same level of detail and concern as if the lender were a potential landlord of the building, or negotiating or approving the lease in the first instance. This approach is unusual.

Instead, a lender will typically assume that most of the non-fundamental terms of an existing lease are commercially tolerable, because: (a) the lender isn't really the landlord; (b) the lender's loan-to-value ratio means that the lender can live with some imperfections in the leases (other than substantial direct threats to reliability of cash flow); (c) such imperfections are unlikely to cause the lender to walk from the deal, so they are not worth the time they would take to find; and (d) more generally, full review of every term of every lease makes no practical or economic sense.

The following issues represent the lease issues that any lender will probably place at the top of its list. Most of these issues are not directly economic, but affect possible interruption or loss of income, the lender's primary concern. Others affect a range of lender concerns not necessarily tied to loss of income.

5 For a description of many of those issues, see the various chapters of this book, and particularly the Tenant's and Landlord's Silent Lease Issues checklists reprinted as Chapters 3 and 4.

A. Casualty and Condemnation

A lender will want to assure that if the building burns down or a government acquires it for public use, the lender understands how that loss will affect rental income and the continuation of the leases in the building. The lender does not necessarily expect tenants to continue paying rent if they can't occupy their spaces. In fact, a lease that imposes such a requirement may create more problems than it solves.[6] Here is a short summary of the lender's agenda in this area, when considering a routine space lease:[7]

- *Rent Abatement.* Understand and summarize when and how the lease allows the tenant to abate rent after a casualty or condemnation. Typically, a lender will accept reasonable rights to abate rent in proportion to the tenant's inability to use its premises. A lender will even usually tolerate provisions that allow a tenant to terminate its lease if the unusability continues for a certain period. The lender also wants to confirm that the provisions allowing the tenant to abate rent and terminate the lease make sense and are matched by the borrower's insurance coverage.

- *Where's the Cash?* If a loss occurs, the lender's worst fear will be that the tenant will be able to receive some share of the insurance or condemnation money that would otherwise go to the lender—so these funds won't be available for the lender—or a tenant will be able to require the borrower to apply those funds in a manner inconsistent with the loan documents. So the lender's counsel should understand exactly what the lease requires along these lines, and identify any inconsistencies or issues. Strong tenants will often insist that any inconsistencies between their lease and the loan documents be resolved in favor of the former. A lender will usually tolerate such a provision as long as the lease allows insurance or condemnation proceeds to be used to restore, with any excess reverting to the landlord and its lender, all under terms and conditions that the lender can accept.

- *Restoration Procedures.* If the lease does require the landlord to restore, the lender will want to confirm that nothing in those restoration procedures will create risks or concerns for the lender. As an extreme exam-

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6 Such a lease forces each tenant to insure a risk that in most cases is more efficiently (i.e., cost effectively) insured once, at the landlord level. If a tenant fails to maintain that particular insurance, the landlord cannot look to its own insurance to fill the gap, but must instead look to the tenant's credit and the landlord's remedies under the lease. If, on the other hand, the landlord had agreed to abate rent, the insurance carrier would probably give the landlord a simpler and more reliable mechanism to make up for the loss.

7 If the lease is a ground lease, synthetic lease, or a bondable lease, the lender's expectations will be quite different and are outside the scope of this book.

ple, if the lease requires the landlord to restore but provides that a non-creditworthy (or potentially non-creditworthy) tenant will hold the restoration funds while the process goes forward, a lender would regard such a provision as troublesome. A lender will also want to satisfy itself that if landlord actually does restore, the tenant will remain in place under the lease, and the deadline to restore is not unrealistically short.

B. Go-Dark

If the lease covers retail space, the lender will want to confirm that—at a minimum—the lease requires the tenant to open for business by a certain date. The lender will then want to assure that the tenant must continue to operate after opening. This issue will be particularly important for large "anchor" stores, which typically pay a lower rent based on the assumption that by being open for business they will attract customers for the benefit of everyone else at the property.

If one of these major tenants has the right to close up its operations at whim, this undercuts the assumption that drove the economics of the lease. Although the lease would require the "anchor" tenant to continue to pay rent after closing, major chain stores have been known to do exactly this when they open a new location across the street and want to prevent a competitor from opening at their former location. Any such closure by an anchor tenant can imperil the viability of other tenants and hence, ultimately, the viability of the entire property. Courts will occasionally infer an "implied" covenant of continuous operation, but no lender wants to rely on that possibility. Lenders and their counsel will therefore usually assume that unless a lease obligates the tenant to operate, the tenant is free to shut down, which will raise a concern.

If a retail lease does not contain a covenant to operate, then counsel should flag that omission as an issue. But a lender will typically not be concerned about reasonable exclusions from the covenant to operate, such as temporary closures for purposes of taking inventory, constructing alterations, or the like—as long as the exceptions are not so broadly worded that they consume the rule.

Although tenants will sometimes agree to remain open and continue operating without qualification, most tenants refuse to incur such open-ended obligations, arguing that if it no longer makes business sense to remain open they should not be obligated to do so. As a common compromise, major tenants often agree that if they shut down for a certain period, the landlord has the right to terminate the lease. The details and mechanics of these landlord

termination rights will vary from project to project, but will be extremely important to a lender in every case. Some examples:

- *Landlord's Kickout Payment.* If the landlord must pay the tenant when terminating the lease (e.g., "reimbursement" of the tenant's fixturization costs), how will the landlord obtain the funds for that payment? The lender will realize that if the need ever arises to make that payment and then find a new tenant for the space, the borrower will probably try to persuade the lender to advance the necessary funds, which the lender may or may not be inclined to do. For that reason, if the lender is concerned about the issue, it may want to establish a reserve.

- *Tenant's Kickout Payment.* Conversely, if the tenant must pay the landlord for any such termination, where does that money go and what will the landlord use it for? The landlord will probably incur costs to re-tenant the space. As a general question, whether or not the tenant must pay for the termination, how will the landlord cover its re-tenanting costs without coming to the lender, hat in hand, looking for more money?

- *Timing.* Does the timing of the termination right give the landlord a reasonable time to find a new tenant before the old tenant goes away? If not, how will the landlord cover the lost income during that period?

- *Control Over Termination.* Is the termination right structured in a way that allows the landlord to control it to the exclusion of the lender, and potentially use that control to leverage the lender? For example, if the termination right is a "one time only" event, the lender may fear that if the borrower and the lender are in litigation at the time the right arises, the borrower might refuse to exercise the termination right even though it makes economic sense for the building—simply to gain leverage in the dispute with the lender. The lender may prefer that the termination right be continuous or at least periodically recurring, so that once the parties resolve their dispute and (hypothetically) the lender owns the building, the lender will still have some reasonable opportunity to terminate the lease.

- *Lender Consent Right.* Conversely, if the lender does not want to terminate the lease but the landlord does, does the lease (or a separate agreement) protect the lender by saying that the termination will not be effective without the lender's consent?

- *Required Activity Level.* What level of activity in the space must the tenant continue to demonstrate in order to protect itself from termination?

Will that level of activity meet the lender's expectations for the space and the project? For example, operation of two subleased flea market booths in the back corner of the space should not suffice to protect the tenant from termination.

For any retail project, issues relating to the tenant's obligation to operate, and the possibility of closure, will often be the near the top of any lender's list. If the lender's counsel does not remember to look for these issues, they are easy to miss because the concern arises more from what's missing than from the words of the lease.

C. Abatement Rights

Does the lease allow the tenant to abate or offset rent? (Disregard casualty or condemnation abatements, which are covered separately, if at all.) A tenant's rights to abate rent will often tie to the tenant's "self-help" rights—rights of the tenant to cure the landlord's defaults and offset the costs against rent. For a major tenant, a lender may simply have to live with these abatement rights. But the lender should begin by understanding exactly what they are. At a certain point they become intolerable.

Ideally, the tenant will not be able to activate any self-help or abatement rights without giving the landlord and the lender plenty of notice and opportunity to correct the situation. Moreover, the tenant's self-help and abatement rights should apply to as few as possible of the landlord's obligations. For example, a lease that lets the tenant abate rent for delays in initial construction or for interference with the tenant's network control center is far more palatable than one that allows the tenant to self-help and abate whenever the landlord defaults in any way.

D. Assignment/Subletting

If a tenant is particularly desirable, the existence and continuation of that tenant may be a substantial element in the lender's approval of the loan. In such cases, the lender may care a great deal about whether the lease allows the tenant to assign or sublet, and under what circumstances. Typically, even if the lease allows assignment or subletting, a lender will live with it as long as the original tenant remains liable under the lease. On the other hand, a lender might take a harder line, saying that the possibility of assignment or subletting creates the possibility of an unexpected change in the character of the property. It all depends on the circumstances, and a lender may care more about these issues for retail property than for office or industrial property. Unless a lender has instructed counsel that special circumstances exist,

any lease review should probably answer the following questions about assignment and subletting under the lease:

- *Assign/Sublet.* Does the lease let the tenant assign or sublet, and if so to what degree and within what constraints? To the extent that the lease grants the tenant flexibility, can the lender tolerate that level of flexibility (and the long-term uncertainty it creates for the landlord and lender)?

- *Release of Liability?* Does the lease contain any language that would allow the original tenant (or its guarantor) to be released from liability upon an assignment? Any such release from liability should be treated as a red flag and brought to the client's attention immediately upon being identified. This issue will be important to the extent that the initial lease obligor is creditworthy, and less important or not important at all if that initial obligor has no meaningful credit.

- *Recapture Rights.* Does the landlord have the right to terminate the lease ("recapture" the space) if the tenant wants to initiate certain types of assignment or subletting? Does the timing work and does the lender want to be involved in these decisions and any related leasing decisions?

- *Change of Use.* Does the lease provide any flexibility for a change of use if the tenant assigns or sublets? Does the flexibility create possibilities that are intolerable to the lender?

E. Cancellation Rights

If a lease allows the tenant to terminate under any circumstance beyond casualty and condemnation (as discussed above), this will probably create substantial concern for a lender. The following are some examples of "bad" termination rights from a lender's perspective:

- *Sales-Based.* Right to terminate for failure to achieve specified level of sales.

- *Co-Tenancy.* Right to terminate if some other tenant (or group of tenants) is no longer in occupancy, or never enters into occupancy.

- *Landlord Default.* Termination rights arising from a possible landlord default.

- *General.* Unilateral right of the tenant to terminate, even if the tenant must make a payment to the landlord.

F. Unreasonable Burdens

A lender will also be concerned about any lease that imposes unusual and atypical burdens on the landlord. In the short term, such burdens may have unpredictable adverse effects on cash flow or increase the likelihood of mistakes, issues, or complexity. In the long term, the lender must see itself as a successor landlord, and it will not want to incur obligations that vary dramatically from those of a typical passive income-producing landlord. Any lender's counsel reviewing a lease should therefore look for any unusual or burdensome obligations or restrictions affecting the landlord, such as the following:

- *Transfer Restrictions.* Prohibitions on transfers by the landlord or by the ultimate owners of equity interests in the landlord. Some restrictions may be perfectly tolerable, but the question in assessing any restriction is whether it will significantly impair the lender's exit strategy.

- *Restrictions on Other Property or Activities.* Anything at all that restricts the landlord's operations, leasing, activities, construction, or use of the landlord's property outside the leased premises. Some examples in this category would include restrictions on signage, "exclusive" rights for a particular tenant, restrictions on leasing to particular types of tenants, obligations to maintain particular parking, "no-build" areas, and the like. Any major lease is likely to contain at least some restrictions along these lines. The job of the lender's counsel is to identify these restrictions—know what to look for—and confirm that the lender knows about them. The lender must then decide whether they create a problem. To the extent that they merely re-state what any reasonable landlord is likely to do (or not do) anyway to maintain an economically viable property, a lender often won't care. But it is ultimately a decision for the lender to make in the context of the project as a whole.

- *Subtenant Recognition Traps.* A substantial lease may allow the tenant to enter into subleases. To facilitate those future subleases, the lease may obligate the landlord to enter into agreements with subtenants ("recognition agreements") whereby the landlord agrees that if the landlord-tenant lease ever terminates, then the landlord will recognize the subtenant as a direct tenant. A tenant's desire to obtain recognition agreements from the landlord is perfectly understandable, but a landlord—and hence a lender—must remember that these agreements could force the landlord to become a direct landlord under whatever sublease the tenant negotiates. Therefore, before a landlord agrees to enter into recognition agreements with any subtenant, the landlord must be com-

fortable that the terms of the sublease will be tolerable to the landlord. In reviewing any landlord covenant to grant recognition agreements to subtenants, a lender must satisfy itself that the landlord will never be obligated to recognize subtenants on terms that the landlord might find intolerable.

- *Unusual Obligations.* Does the lease impose on the landlord any obligations that are difficult to perform, not capable of being quantified, or outside the scope of typical landlord obligations under a lease? As an example, a lender may be concerned if a lease allows the tenant to require future upgrades to building systems without defining what those upgrades are.

G. Options

Although expansion and renewal options in and of themselves are not troublesome, they can create serious problems if they are: (a) significantly below market; (b) conflicting; or (c) scheduled in a way that denies the landlord sufficient time to find a replacement tenant if an option is not exercised. Parsing out the options over time can be a very large project, which someone else can do or has probably done (but whose work should probably be checked). If the leases suggest that such an exercise may be necessary, counsel should call the concern to the lender's attention and seek the client's advice on how to proceed. Any purchase option, or even a right of first refusal to purchase, should raise an immediate red flag. Such options are very atypical in space leases and can create substantial concern for a mortgage lender.

H. Exculpation

Does the lease provide that, no matter what, the landlord's liability will be limited to its interest in the premises? Any landlord and any lender will always want to see such a provision, although a lender that really wants to make a particular loan can usually figure out a way to live without such language. The lender can, after all, probably form a single-asset entity to bid at the foreclosure sale and take title to the asset if the need arises. That way, the lender may be able to get comfortable with the lack of an "exculpation" clause, although a conservative lender may be concerned about the risk of forgetting about the problem and taking title in its own name.

I. Protection on Alterations and Contest

Many leases give a tenant some flexibility in two areas that can produce direct economic loss to the landlord: alterations and the tenant's right to challenge the validity of legal requirements that apply to the building.

In the case of alterations, if the tenant does not pay for any construction work, the unpaid contractors and other parties may have the right to file a mechanic's lien. In some states, that lien attaches to both the tenant's leasehold and to the landlord's fee estate (and occasionally obtains priority ahead of the lender's mortgage). The landlord (and sometimes even the lender) may therefore find it needs to pay the tenant's construction bills in order to protect itself from a foreclosure under the mechanic's lien.

Similarly, if the lease allows the tenant to contest the application of particular legal requirements, the landlord may be stuck with the adverse consequences if the tenant's contest fails and the tenant chooses not to, or is unable to, comply with the legal requirements as finally determined.

A landlord may mitigate each of these risks by requiring the tenant to post a bond if the lien or amount at issue in a legal contest exceeds a certain level, depending on the size of the lease and the landlord's comfort with the tenant. A lender will have similar concerns, but often more strongly felt than the landlord's. A landlord may be willing to waive any requirement for bonds, in the interest of "getting the deal done," but a lender may not want to be as flexible and accommodating.

Therefore, if a lease does not require the tenant to post bonds under the circumstances described here, the lender's counsel should at least bring the omission to the lender's attention.

J. Concessions to Creditworthy Tenants

Leases with unusually creditworthy tenants—such as a chain store that has not yet filed bankruptcy—will often contain concessions to the tenant that are premised on the assumption that the tenant is creditworthy. For example, such tenants will often not be required to post bonds of the type suggested in the preceding section, because the landlord believes the tenant's credit is good enough that such bonds are unnecessary. But that is only the beginning. The landlord may dispense with a security deposit, loosen the "use" clause," agree to significant restrictions outside the leased premises, give the tenant extra flexibility regarding its activities in the space, and on

and on, all premised on the notion that the tenant is creditworthy and therefore these concessions make sense.

But what happens if the premise turns out to be wrong? To the extent that the lease contains concessions to the tenant based on that tenant's credit quality, the landlord (and particularly the lender) may want those concessions to go away if the tenant's credit quality goes away. Any such "concession clawback" provisions are quite unusual, but recent history—particularly with chain retailers once regarded as having invincible credit—demonstrates that such "clawbacks" may turn out to be quite important and relevant.

To the extent that (a) a lender is uncomfortable with any tenant-oriented concessions that were premised on the assumption that the tenant is creditworthy, but (b) the lease does not provide for a "concession clawback" if the tenant becomes less creditworthy, then lender's counsel may want to highlight that fact for the lender's consideration.

VI. LENDER PROTECTION ISSUES

For most of the issues discussed so far in this chapter, the concerns of the borrower (landlord) and the lender (possible future landlord or seller to the next landlord) are quite similar. Both share each of these concerns, although a lender may care more than a borrower because of the lender's more conservative orientation. For another group of issues, though, a landlord or borrower will probably have no direct interest at all. Instead, the landlord or borrower will only have an indirect interest in making sure that a lender—today's or tomorrow's—will not object to the lease.

The issues in this latter category relate to the relationship between the tenant and the mortgagee and the effect of a loan default or other possible problems with the mortgaged property. Any lender's counsel reviewing a lease will want to consider these issues, although their importance will vary depending primarily on the size and importance of the lease, as well as on other circumstances.

A. Estoppel Certificates

Does the lease require the tenant to provide estoppel certificates, i.e., certificates confirming the continued existence and status of the lease, that the tenant has no claims against the landlord, and similar matters? Does it establish any burdensome restrictions or limits on the landlord's right to obtain estoppel certificates? A lender will want the tenant to be unambiguously

obligated to deliver an estoppel certificate for today's closing, as well as for any future closing. And the lender will be uncomfortable to the extent that anything in the estoppel certificate might limit the lender's (or a future lender's) ability to rely on it.

B. Priorities

In a lender's perfect world, the lease will simply say that it is subordinate to all mortgages. But leases with substantial tenants rarely contain such a provision. Instead, "subordination" will at a minimum be conditioned on the lender's entering into a "nondisturbance" agreement. These agreements and this relationship create a host of issues, which are generally far more trouble than they are worth and are discussed at great length in Chapter 24. For purposes of a lease review, the lender's counsel merely needs to understand what the lease says about this issue. Specifically, the lender's counsel should answer these questions:

- *Subordination.* Does the lease state it is subordinate to mortgages?
- *Nondisturbance.* If so, is subordination conditioned on the lender delivering a "nondisturbance" agreement?
- *Conditions.* What are the requirements for that "nondisturbance" agreement? Will the lender be willing and able to satisfy them?

A lender would prefer to see any subordination clause be as simple and straightforward as possible, with no need for the lender or landlord to remember to do anything at all. If the lease conditions "subordination" on the lender's entering into a nondisturbance agreement, then the lender's counsel needs to note this fact and have the necessary agreement entered into as part of the closing.

If the lease requires a nondisturbance agreement that requires the tenant's approval, a careful lender will assume that the tenant will never approve the agreement, and therefore the subordination will never become effective. When a lease contains such a requirement, counsel should flag it and bring it to the lender's attention as early as possible. For a major tenant, the lender will probably want to resolve any such uncertainty at the time of the closing, as a condition to making the loan. Whatever resolution the parties craft, it should apply not only for today's loan closing but also to any future loan closing.

C. Attornment

Does the lease require the tenant to "attorn" to anyone who purchases the property at a foreclosure sale (i.e., in most cases, the lender)? What are the conditions and limitations of this "attornment"?

D. Cure Rights

If the landlord ever defaults under the lease, particularly in a way that might entitle the tenant to terminate, a lender might want the right to receive notice of the default and to try to correct the situation. For that purpose, a lender might want some additional time—beyond whatever time the lease gives the landlord. Provisions of this sort are particularly important for leases with major tenants, but even then they will usually give the lender only a fairly limited additional cure period—far from the degree of additional protection that a lender would expect to see in, for example, a ground lease.[8] In the author's experience, leases will often give a lender 30 extra days to cure the landlord's default, and very rarely much more time beyond that. Unlike the case in a ground lease, the termination of a space lease does not deprive the lender of its entire collateral—merely a part of the rental income. And it is not reasonable to expect the tenant to wait around for very long while the lender tries to cure the tenant's default. The tenant needs to be able to operate a business in the leased premises. So, although a lender will often expect to have a right to cure the landlord's default, the cure right may ultimately not be all that extensive. Whatever it is, the lender's counsel should note it as part of the lease review.

E. Direct Rent Payment

If the loan goes into default, a lender will typically obtain the appointment of a receiver to collect rental income from the property. A lender may, however, seek an extra level of flexibility by having the right to require the tenants to pay rent directly to the lender after a loan default, even if the lender has not yet appointed a receiver. In a lender's perfect world, the lease would contain provisions to this effect, so that the lender (and the borrower) would not need to obtain a separate agreement with the tenant. More typically, however, separate agreements of this type are required. The issue remains one that counsel may want to look at and mention during any lease review.

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8 *See, e.g., supra* note 1 (articles on ground leases).

F. Conditions to Lender Protections

To the extent that the lease builds in protections for a lender of the types suggested in this section, counsel will want to scrutinize those protections to understand what conditions need to be satisfied in order for them to be activated. For example, if the lease requires notice to be given to the tenant before the lender will qualify for a particular protection, the lender will not want to rely on the landlord to remember to give that notice. The lender's counsel should add it to the closing checklist and make sure it happens.

G. One Last Category of Issues

In addition to all the lease-related issues previously covered in this chapter, the lender's counsel should watch for any provisions in the leases that seem unusual or "weird"—anything that might create out-of-the-ordinary issues or problems. These provisions might include unusual tenant rights, unusual conditions to the tenant's obligations, evidence of a past dispute that may still fester, uncertainty about either party's obligations, evidence of possible zoning problems or disputes, unusual limitations on the landlord's remedies for default, or anything else that could undercut the lender's assumptions about the lease as summarized in Section I.