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A Lender's View of Key Provisions in Commercial Leases:

The Three P's of "Profit," "Property Condition," and "Priority"

The negotiation of commercial real estate leases often can be a delicate balancing act, with many interested parties holding a stake in the outcome. The successful drafting of a lease often depends on how skillfully the interests of each party are balanced with the interests of the other parties. The interests of the lender in this balancing act form a distinct set of considerations unlike those of the landlord or tenant. This article will explore the three principal considerations behind the lender's review of a lease, and the significant lease provisions in which these considerations come into play. This is not intended to be an all-inclusive treatise on commercial leasing, but rather a review of key lease provisions of particular interest to lenders.

Profit, Property Condition, and Priority

Three main considerations come into play when analyzing a commercial real estate lease from the viewpoint of the lender: Profit, Property Condition, and Priority. The lease is an asset with value from a cash flow perspective. Income net of expenses, or profit, should flow from the tenant to the landlord and, ultimately, to the lender. Any provision of the lease that would affect the flow of income to the landlord, such as the creditworthiness of the tenant, would fall in this category. The condition of the property securing the mortgage is also a paramount consideration. Any lease provision that could affect the condition of the property, such as alterations or improvements to the structure,

environmental contamination, or changes in use, would be of interest to the lender. Finally, the lender must ensure that no provision of the lease could affect the priority of the mortgage or the condition of the title. The lender will always want to have priority over the lease or third-party claims. For example, the payment of all real estate taxes should be ensured by a charge as rent, if necessary, because unpaid real estate taxes could place not only the mortgage priority but the very existence of the mortgage in jeopardy if the property is sold at a tax sale.

These three principal considerations should be kept in mind at all times when negotiating and reviewing a commercial lease on behalf of the lender. As will be seen, one or more of the Three P's play a role in several significant provisions of the lease.

Significant Lease Provisions

The following lease provisions are those of significant concern to the lender. Special care should be taken to ensure that the language of the lease protects the interests referenced by the three principal considerations mentioned above.

Tenant/Guarantor Creditworthiness (Profit, Property Condition, Priority)

The creditworthiness of the tenant and/or its guarantor, if applicable, should be investigated thoroughly. The tenant is the foundation upon which the income or cash value of the lease asset is built. A creditworthy tenant will ensure an uninterrupted flow of income, in the form of rent, to the landlord, and ultimately to the lender via mortgage payments. The lender should verify that a prospective tenant is creditworthy in order to minimize any potential for interruption of rent payment to the landlord, and any consequent interruption of mortgage payment to the lender. A tenant that lacks creditworthiness may significantly affect the value of the lease as asset.

Tenant creditworthiness may also affect the condition of the mortgaged property. If the tenant has responsibility for maintenance and repair of the property through a net lease, the condition of the property may suffer in the hands of a tenant in default. Deferred or improper maintenance due to failure of the tenant to satisfy its obligations under the lease will affect the value of the property.

Additionally, a tenant in default may be unable to pay contractors hired to maintain or repair the property. In this situation, the tenant may expose the lender to a loss of mortgage priority due to mechanics liens filed against the property for nonpayment by the tenant. In some states, mechanics liens take priority over the mortgage. Failure to properly investigate the creditworthiness of a tenant may lead to significant consequences should the tenant default.

While a creditworthy tenant is usually preferred, tenant creditworthiness may affect the ability of the lender to secure desired lease provisions. A creditworthy tenant will be in a stronger negotiating position than a tenant with average credit. Consequently, a strong tenant may be able to demand rights and lease terms that are contrary to other interests of the lender. The promise of secure income flow from the lease asset must be balanced with the need to protect other terms of importance to the lender's interests.

Early Termination (Profit)

The right of a tenant to early termination of the lease should be non-existent or severely restricted. For example, a tenant's right to terminate a lease could be limited to situations in which a landlord material default has not been cured only after ample time to do so, while also giving the lender notice and the opportunity to cure the default. Early termination will interrupt the flow of income from the lease, and will leave the landlord

without income for the weeks or months it may take to mitigate the circumstances that led to default and find a replacement tenant.

In some instances, a tenant may negotiate an early termination right with the landlord as part of its economic package under the lease. If the lender is privy to the landlord-tenant negotiations, and aware of the early termination right, the value of the lease may be adjusted appropriately.

Set-off and Abatement (Profit)

Like early termination, the right of the tenant to set-off rent payments due to landlord default should be non-existent, or severely limited if given at all. The interruption of income flow caused by a setoff will hinder the ability of the landlord to correct the default, as well as delay payments to the lender. The lender should be notified of any set-off or abatement. Additionally, there should be no set-offs or abatements not expressly provided in the lease.

Notice (Profit, Property Condition, Priority)

Key to early termination, setoffs, and many other lease provisions, adequate notice of any change that will affect the value of the lease as an asset, the condition of the property, or the primacy of the mortgage holder in claims to the property should be provided to the lender. The lender should be listed as a party to be notified of any changes to the lease terms, changes in tenant(s) or use, alterations to the property, and any default by tenant or landlord.

Renewal Options (Profit)

A primary concern of the lender the lease as an income-producing asset. The lender desires to maximize the value of the lease to ensure a constant flow of income to

the landlord mortgagee and an increase in the value of the mortgaged property. With this in mind, any option for renewal of the lease should establish the renewal rent at market value. If market value is not easily ascertained, the lease should specify a process for determining market value. The intent behind these protections is to prevent uncertainty and avoid loss of income due to renewal options that do not account for changes in the value of the leasehold.

Gross or Net Lease (Profit, Property Condition, Priority)

The lender seeks to limit landlord operating expenses as much as possible. To that end, net leases are preferred. All responsibility for maintenance of the property, utilities, insurance, and taxes should rest with the tenant. A net lease eliminates most possibilities for landlord default and set-offs, and maximizes income flow from the lease.

As mentioned above, maintenance and repair obligations assigned to a tenant through a net lease may affect the property condition should the tenant fail to fulfill the obligations. Such failure may subsequently affect the priority of the lender, due to mechanics lien claims against the property for unpaid maintenance and repair work.

Tenant Improvements (Profit, Property Condition, Priority)

Tenant improvements to the leased premises could have negative or positive affects on the value of the property. A significant improvement, such as a resurfaced parking lot or new landscaping, may increase the value of the property and leasehold. Other improvements, such as those that could restrict the future use of the property, may negatively affect property value. In both cases, the lender should retain some control over review of proposed tenant improvements to protect the value of the property from

harm. For impermanent or moveable items, the lease should specify whether the tenant has the right to remove improvements at the end of the lease term.

Tenant improvements also carry with them the possibility of interfering with the priority of the lender's mortgage interest in any claim against the property. Should a tenant default on lease payments, they will likely be unable to pay the providers of furnishings, fixtures, and construction services as well. This may create a situation in which the mortgage interest becomes subordinate to a mechanics lien claim. The lender will seek to avoid this situation. If tenant improvements are permitted, the landlord should reserve the right to satisfy any third party lien claim against the property, with the expense incurred charged as rent. Additionally, notice of any tenant improvements and third party claims should be provided to the lender.

Alterations to the Property (Property Condition)

The lender should be provided notice of any structural alterations to the property, as well as any alterations likely to affect the value of the property. This provision should include alterations by both the landlord and the tenant. As the security for the mortgage, the condition of the property is of primary interest to the lender. Any alterations that may damage the property or otherwise affect its value should be avoided. Lender review of proposed alterations will protect the condition of the property and, consequently, its value.

Damage or Destruction (Profit, Property Condition)

In the event of destruction, any rights of the tenant to terminate the lease should be restricted. If timely repair is possible, the tenant should not be able to terminate the lease. Only in the event of complete destruction or substantial damage should

termination by the tenant be an option. Conversely, the landlord should reserve the right to terminate the lease should partial or total destruction occur. This may arise in a situation where restoration of the property is possible, but not preferable. The landlord should retain the right to terminate any leases and build new, to maximize the value of the property.

Additionally, disbursement of any insurance proceeds due to the destruction of the property should be controlled by the landlord. Insurance required by the lease should cover not only the value of the property, but also the cost of full restoration. The lender should be named as an additional insured on the damage or destruction insurance policy. Restoration obligations should be limited to the amount of the insurance payment.

The landlord should also be required by the terms of the lease to carry rental interruption insurance, to ensure the continued flow of rental income during any abatement or repair period made necessary by damage to the property.

Condemnation (Profit, Property Condition)

As with damage and destruction, the tenant's right to terminate the lease in the event of condemnation should be limited. Termination should be restricted to situations where the entire property is condemned or where the extent of condemnation renders the tenant's use of the leased premises impossible or difficult. Reduction of the rent and a continuation of the leasehold on the property unaffected by condemnation should proceed without interruption.

Any proceeds resulting from condemnation should be paid to the landlord, with none allocated to the tenant by agreement or otherwise. The tenant may seek compensation for their loss due to the condemnation independent of the landlord's claim.

The lender should be notified of any condemnation proceedings against the property, as the value of the property will likely be affected.

Default by Tenant (Profit)

Lease provisions concerning default by the tenant should reserve every right available under applicable state law. The landlord should reserve the ability to move quickly in the event of tenant default, in order to preserve the stream of rental income from the leasehold. Federal bankruptcy laws may control in the event of tenant default, but every right available should be preserved for the landlord and/or lender.

Estoppel Certificate (Profit, Property Condition, Priority)

The tenant should be required to provide to the lender upon request an estoppel certificate certifying the terms of the lease, the lease status, and any other items specified and required by the lender.

Leasehold Mortgages (Priority)

The Tenant should be prohibited from entering into leasehold mortgages, and from taking any other action that may cloud title to the property or endanger the primacy of the lender's interest.

Payment of Taxes (Priority)

The tenant should be required to pay all of the taxes levied on the property as part of the net lease or, in multi-tenant properties, their proportion of the taxes due. The landlord should reserve the right to pay any delinquent taxes due in the event of tenant failure to pay, with the expenditure charged as additional rent. This provision protects the lender's interest in the property from any government claims and possible tax sales.

Use Restrictions (Property Condition)

The lease should contain strong language that restricts the tenant from engaging in any uses that may damage the property, such as those involving hazardous or toxic materials. Hazardous materials may damage the property, affecting its condition and value. Hazardous activities may also burden the title to the property, should government enforcement actions due to environmental contamination occur. Unless specifically provided for, any uses that involve toxic or otherwise hazardous materials or activities should be prohibited by the lease.

Subordination, Non-Disturbance, and Attornment (Profit, Priority)

In the event of foreclosure, tenants should be required by the terms of the lease to attorn to the lender and to any new landlord designated by the lender. This will ensure continuity of income from the leasehold and secure the value of the property for sale.

After the lender or buyer takes title to the property following foreclosure, the lender is concerned about possible ongoing obligations may be owed to the tenant for any defaults of the prior landlord. The lender wants to limit the responsibility of it or subsequent purchasers after foreclosure for any defaults or unfulfilled obligations of the previous landlord. The tenant should be limited to seeking satisfaction for any outstanding obligations from the original landlord, with the lender and new owner responsible only for obligations made during their possession of the property.

This provision should extend to all obligations of the previous landlord. The lender, assignee, or buyer should not be liable for the return of any security deposit funds for which they have not received an assignment. Correspondingly, neither the lender, assignee, or buyer should have responsibility for recognition of any prepaid rent. Any

tenant improvement allowances promised by the previous landlord for late in the lease term remain the responsibility of the prior landlord alone, not the lender or buyer.

Subleases and Assignments (Profit, Property Condition, Priority)

The tenant should be required to receive the approval of the landlord for any subleases or assignments. As with the principal tenant, the creditworthiness of any sublessees or assigns should be thoroughly investigated. Notice of any sublease or assign should be given to the lender. In the event the tenant wishes to vacate a portion of the leased premises, the landlord should reserve the right to abate the rent of the unused area and re-acquire the vacated portion for re-lease, in lieu of a sublease by the tenant.

Conclusion

The provisions mentioned above deserve careful attention when reviewing a lease on behalf of a lender. Each provision involves one or more of the primary considerations of lenders in regard to commercial real estate leases. Wherever a lease provision may affect the stream of income from the leasehold, the condition of the mortgaged property, or the primacy of the lender's interest in the property, the provision should be drafted to with protection of the lender in mind. The Three P's of Profit, Property Condition, and Priority should serve as a guide for approaching lease provisions from the perspective of a lender.