

Solutions to Common Lender Issues

Jeffrey C. O'Brien

Mansfield Tanick & Cohen, P.A.

© 2007 Mansfield Tanick & Cohen, P.A.

A. Introduction

In this era of low interest rates and multiple financing options, most commercial property is subject to some kind of financing. The fact that commercial property is financed means that a third party – i.e., the landlord’s lender – is affected by the lease(s) for the property and this third party must have its concerns addressed within the lease in order for all parties to have a smooth relationship.

When discussing lending in the context of commercial rental property, everyone must bear in mind the fundamental principle of what makes such property profitable; that is, the principal – if not exclusive – value of the property to the landlord/borrower is the income stream which the leases generate. Hence, a lender’s credit underwriting decisions are often based primarily on the quality of the tenants, the amount of the rents, the duration of the terms of the leases and other pertinent terms and conditions of the leases. In some respects, the creditworthiness of the tenants is a more important consideration for a lender than the creditworthiness of the borrowers/landlords themselves.

This section discusses various ways to manage the lender-landlord/borrower-tenant relationship through proper drafting and negotiation of commercial leases and other related documents.

B. Be Aware of Lender Approval and Modification Rights

As part of its underwriting process, the lender will require review of all of the terms and conditions of any leases in place with respect to the property. The lender’s concern, of course, will be to look for objectionable lease terms which the lender believes could affect the cash flow from the property to be financed and, in some instances,

require modifications to these provisions. Examples of lease provisions which a lender may object to include:

- The right of the tenant to buy out of the lease; i.e., the right of the tenant to pay the landlord a one-time fee to terminate the lease early.
- The tenant has an option to purchase the property.
- The tenant has the right to make repairs and offset the cost thereof against rent.
- Damage and destruction (or condemnation) provisions in the leases which are contrary to the lender requirements for the use of insurance proceeds following damage or destruction to the property, or the use of the condemnation award following a condemnation of all or a portion of the property.
- A single tenant (or small group of tenants) lease an excessively large percentage of the property.
- Outstanding landlord obligations to fund tenant improvements.
- Rent-free periods under the lease.
- Other monetary concessions made to the tenant.

From the landlord's perspective, care should be taken to avoid conceding to the tenant on provisions which, in the event the landlord later refinances the property, the new lender will object to and seek to remove (and thereby create problems for the landlord's relationship with its tenant). From the tenant's perspective, the tenant must be aware that asking for too many of the above provisions may pose later problems.

In some instances, a lender will negotiate with the landlord/borrower a standard form lease which is to be used with any future tenants. Again, the landlord and tenant must be realistic in wavering from the provisions of the form lease and must keep in mind

the “Golden Rule” – i.e., “he who holds the gold makes the rules.” When the lender holds the purse strings, both the landlord and the tenant must accept the constraints imposed by the lender as to the lease transaction.

Notwithstanding the lender’s initial review and approval rights as to existing leases, the lender will likely reserve continuing approval rights throughout the course of the leasing relationship. A prime example of this pertains to assignment and sublease provisions. Most commercial leases will require the landlord’s written consent as to any assignment or sublease to a third party. The rationale for this provision is, of course, to provide the landlord with the ability to review and approve the creditworthiness of the potential replacement tenant (note: think back to the primary motivation behind commercial rental property – cash flow is king). To take this one step further, many lenders will require that in addition to landlord consent, the lender must also consent to any proposed assignment or subletting.

C. Minimize Exposure to Cash Flow Risks

When cash flow from leased commercial property is tight, landlords/borrowers feel the squeeze when the property is financed. This is because, rather than applying the rental income stream from the tenants to cover the landlord’s holding costs of the property, the landlord is instead paying such costs out of pocket. If such a situation continues for an extended period of time, the landlord defaults on its loan and the lender steps in to operate the property. Neither party wants this to happen, and thus ensuring adequate cash flow from the property is a paramount concern.

Assurance of adequate cash flow can be accomplished through proper lease drafting. In fact, a handful of basic lease provisions can, if properly drafted, make the lease “financeable.” These basic provisions include the following:

- The lease should clearly state the identity of the tenant and any guarantors.
- Each lease in existence for the property should be executed by the tenant named as the tenant in the lease.
- The premises to be rented by the tenant should be clearly identified in each lease.
- Each lease should also include the tenant’s express covenant to pay rent and other charges at specific times in advance.
- The amounts due under the lease should be clearly stated.
- The term of the lease, and any options to extend (and conditions for exercising the option), should be clearly stated.
- Default provisions which provide for a wide array of landlord remedies upon a tenant’s default, including rights to terminate the lease, evict a tenant, relet the leased premises and collect damages from the previous tenant.
- Rights of the lender to approve a proposed assignee/subtenant.
- Limitations on the tenant’s right to terminate the lease.

D. Default Consequences and How to Avoid Them

As mentioned above, the key to a successful financing transaction regarding commercial rental property is the assurance of adequate cash flow from rents such that these funds can cover the landlord/borrower’s payment obligations to the lender. Hence, when discussing defaults, most landlord/borrower defaults center around interruptions in this cash flow. These interruptions result in the landlord paying its obligations to the

lender out of pocket and, if continued long enough, will result in the exhaustion of landlord's funds, default and foreclosure.

As noted above, landlords can minimize cash flow risks through proper lease drafting. Another example of minimizing these risks is a landlord's policy of leasing only to franchised businesses (in the retail context) in order to ensure a backup income stream from the franchisor if the business goes dark.

Payment defaults, however, are not the only type of defaults in the financing transaction. The landlord will likely make representations and warranties to the lender as part of the loan transaction as to the existing leases. With regard to these issues, tenant estoppel letters (or estoppel certificates) can be used such that the tenant verifies the underwriting assumptions made by the lender regarding the loan's ultimate repayment source (i.e., the income stream from rents). A wise landlord will include in the lease a provision which requires its tenant(s) to deliver an estoppel letter/estoppel certificate whenever requested by the landlord and/or landlord's lender.

E. Negotiate Subordination, Non-Disturbance and Attornment Agreements

As noted above, the lender wants to ensure uninterrupted cash flow, even if the borrower defaults. They attempt to do so by entering into a Subordination, Non-disturbance and Attornment Agreement ("SNDA") with each tenant of the property and the landlord before the loan closes.

Three key concepts are involved in an SNDA:

- **Subordination** is an agreement to allow another's interest in real property to have priority over one's own interest; lenders typically require that

tenants subordinate their leasehold interests to the lien of the first mortgage.

- **Non-disturbance** means an agreement by the lender to recognize the tenant's rights under the lease after a foreclosure.
- **Attornment** is the tenant's acknowledgment of its obligation to a new, substituted landlord after any transfer of the landlord's interest.

A sample SNDA is included in Appendix A to this Section.

With regard to new property, a landlord will have little to no objection to the terms of the SNDA unless they are so onerous that the SNDA poses a problem for the landlord's ability to find tenants. Where problems arise is in the context of a landlord seeking financing for an already occupied building, as existing tenants seek concessions from the landlord in exchange for their execution of the SNDA. In this instance, the landlord can minimize this problem by including in the initial lease a generic provision which requires the tenant to subordinate its interest to a mortgagee and to execute documentation necessary to give effect to this covenant.

F. Resolve Other Lender Concerns and Considerations

Every financing transaction carries with it unique circumstances that must be dealt with. Lender's may want to review and modify maintenance agreements, management agreements and other agreements executed by landlord. Other lenders may find holes in landlord's current operating structure and require changes. While there is no single way to deal with these issues, landlord/borrowers must realize the fact that the lender holds the purse strings on the financing and the lender will not close the loan until it is satisfied as to the minimization of its risk on the property.

G. Conclusion

In order to avoid later headaches when seeking financing (or a refinancing) of commercial lease property, the provisions discussed in this section should be included in any commercial lease. While there is no way to guarantee that a lender-landlord-tenant relationship will always run smoothly, taking care to think about future consequences during negotiation and drafting of the lease will minimize the inevitable problems in the relationship.

APPENDIX A

SUBORDINATION, NONDISTURBANCE AND ATTORNMENT AGREEMENT

This Subordination, Nondisturbance and Attornment Agreement (the "**Agreement**") is dated as of the ___ day of _____, 2007, between *** (the "**Lender**") having an address at ***, and *** (the "**Tenant**") having an address of ***.

RECITALS

1. Tenant is the tenant under a certain Lease (the "**Lease**"), dated ***, of premises described in the Lease (the "**Premises**") located at ***, and constituting a portion of the real property more particularly described in Exhibit A attached hereto and made a part hereof (being hereinafter referred to as the "**Property**"). *** ("**Landlord**") is the current landlord under the Lease.

2. This Agreement is being entered into in connection with a mortgage loan (the "**Loan**") being made by Lender to Landlord, to be secured inter alia, by: (a) a first mortgage on the Property (the "**Security Instrument**") to be recorded in the real estate records of *** County, Minnesota (the "**Official Records**"); and (b) a first assignment of leases and rents on the Property (the "**Assignment of Leases and Rents**") to be recorded in the Official Records. The Security Instrument and the Assignment of Leases and Rents are hereinafter collectively referred to as the "**Security Documents**".

AGREEMENT

For mutual consideration, including the mutual covenants and agreements set forth below, the receipt and sufficiency of which are hereby acknowledged, the parties hereto agree as follows:

1. Tenant agrees that the Lease is and shall be subject and subordinate to the Security Documents and to all present and future advances under the obligations secured thereby and all renewals, amendments, modifications, consolidations, replacements and extensions of the secured obligations and the Security Documents, to the full extent of all amounts secured by the Security Documents from time to time. Said subordination is to have the same force and effect as if the Security Documents and such renewals, modifications, consolidations, replacements and extensions thereof had been executed, acknowledged, delivered and recorded prior to the Lease, any amendments or modifications thereof and any notice thereof.

2. Tenant agrees that, in the event of a foreclosure of the Security Instrument by Lender or the acceptance of a deed in lieu of foreclosure by Lender or any other succession of Lender to fee ownership, Tenant shall attorn to and recognize Lender as its landlord under the Lease for the remainder of the term of the Lease (including all extension periods which have been or are hereafter exercised) upon the same terms and conditions as are set forth in the Lease, and Tenant hereby agrees to pay and perform in

favor of Lender all of the obligations of Tenant under the Lease as if Lender were the original lessor under the Lease.

3. In the event that Lender succeeds to the interest of Landlord under the Lease, Lender and Tenant hereby agree to be bound to one another under all of the terms, covenants and conditions of the Lease for the balance of the term of the Lease, and so long as Tenant complies with and performs its obligations under the Lease, Lender shall not disturb Tenant's possession of the leased premises.

4. Tenant agrees that, in the event Lender succeeds to the interest of Landlord under the Lease, Lender shall not be:

(a) liable for any act or omission of any prior Landlord (including, without limitation, the then defaulting Landlord), or

(b) subject to any defense or offsets which Tenant may have against any prior Landlord (including, without limitation, the then defaulting Landlord), or

(c) bound by any payment of rent or additional rent which Tenant might have paid for more than one (1) month in advance of the due date under the Lease to any prior Landlord (including, without limitation, the then defaulting Landlord), or

(d) bound by any obligation to make any payment to Tenant which was required to be made prior to the time Lender succeeded to any prior Landlord's interest, or

(e) accountable for any monies deposited with any prior Landlord (including security deposits), except to the extent such monies are actually received by Lender in segregated cash amounts identified to Lender in writing as such at the time received, or

(f) bound by any termination, amendment or modification of the Lease made without the consent of Lender; or

(g) obligated to complete any improvements or construction on the Property or to pay or reimburse Tenant for any tenant improvement allowance or construction allowance; or

(h) be required after a fire, casualty or condemnation of the Property or Premises to repair or rebuild the same to the extent that such repair or rebuilding requires funds in excess of the insurance or condemnation proceeds specifically allocable to the Premises and arising out of such fire, casualty or condemnation which have actually been received by Lender, and then only to the extent required by the terms of the Lease; or

(i) be responsible to provide any additional space at the Property or elsewhere for which Tenant has any option or right under the Lease, or otherwise, unless Lender at its option elects to provide the same, and Tenant hereby releases Lender from

any obligation to provide the same, and agrees that Tenant shall have no right to cancel the Lease and shall possess no right to any claim against Lender as a result of the failure to provide any such additional space; or

(j) be liable for or incur any obligation with respect to any representations or warranties of any nature set forth in the Lease or otherwise, including, but not limited to, representations or warranties relating to any latent or patent defects in construction with respect to the Property or the Premises, Landlord's title or compliance of the Property or Premises with applicable environmental, building, zoning or other laws, including, but not limited to, the Americans with Disabilities Act and any regulations pursuant thereto.

5. Tenant covenants and acknowledges that it has no right or option of any nature whatsoever, whether pursuant to the Lease or otherwise, to purchase the Property or the real property of which the Property is a part, or any portion thereof or any interest therein and to the extent that Tenant has had, or hereafter acquires any such right or option, the same is hereby acknowledged to be subject and subordinate to the Security Instrument and is hereby waived and released as against Lender.

6. Anything herein or in the Lease to the contrary notwithstanding, in the event that Lender shall acquire title to the Property, Lender shall have no obligation, nor incur any liability, beyond Lender's then interest in the Property, and Tenant shall look exclusively to such interest of Lender in the Property for the payment and discharge of any obligations imposed upon Lender hereunder or under the Lease, or otherwise, subject to the limitation of Lender's obligations provided for in Paragraph 4 above.

7. Tenant hereby agrees to give to Lender copies of all notices of Landlord default(s) under the Lease in the same manner as, and whenever, Tenant shall give any such notice of default to Landlord, and no such notice of default shall be deemed given to Landlord unless and until a copy of such notice shall have been so delivered to Lender. Lender shall have the right to remedy any Landlord default under the Lease, or to cause any default of Landlord under the Lease to be remedied, and for such purpose Tenant hereby grants Lender such additional period of time as may be reasonable to enable Lender to remedy, or cause to be remedied, any such default in addition to the period given to Landlord for remedying, or causing to be remedied, any such default. Tenant shall accept performance by Lender of any term, covenant, condition or agreement to be performed by Landlord under the Lease with the same force and effect as though performed by Landlord. No Landlord default under the Lease shall exist or shall be deemed to exist (i) as long as Lender, in good faith, shall have commenced to cure such default within the above referenced time period and shall be prosecuting the same to completion with reasonable diligence, subject to force majeure, or (ii) if possession of the Premises is required in order to cure such default, or if such default is not susceptible of being cured by Lender, as long as Lender, in good faith, shall have notified Tenant that Lender intends to institute proceedings under the Security Documents, and, thereafter, as long as such proceedings shall have been instituted and shall be prosecuted with reasonable diligence. The Lease shall not be assigned (except in the event of an assignment that is permitted in the Lease without Landlord's consent) by Tenant,

modified, amended or terminated (except in the event of a termination that is permitted in the Lease without Landlord's consent) without Lender's prior written consent in each instance. Neither Lender nor its designee or nominee shall become liable under the Lease unless and until Lender or its designee or nominee becomes, and then only with respect to periods in which Lender or its designee or nominee becomes, the fee owner of the Premises. Lender shall have the right, without Tenant's consent, to foreclose the Security Instrument or to accept a deed in lieu of foreclosure of the Security Instrument or to exercise any other remedies under the Security Documents.

8. Tenant has no knowledge of any prior assignment or pledge of the rents accruing under the Lease by Landlord. Tenant hereby consents to that certain Assignment of Leases and Rents from Landlord to Lender executed in connection with the Loan. Tenant acknowledges that the interest of the Landlord under the Lease is to be assigned to Lender solely as security for the purposes specified in said assignments, and Lender shall have no duty, liability or obligation whatsoever under the Lease or any extension or renewal thereof, either by virtue of said assignments or by any subsequent receipt or collection of rents thereunder, unless Lender shall specifically undertake such liability in writing. Tenant agrees that upon receipt of a written notice from Lender of a default by Landlord under the Loan, Tenant will thereafter, if requested by Lender, pay rent to Lender in accordance with the terms of the Lease.

9. If Tenant is a corporation, each individual executing this Agreement on behalf of said corporation represents and warrants that s/he is duly authorized to execute and deliver this Agreement on behalf of said corporation, in accordance with a duly adopted resolution of the Board of Directors of said corporation or in accordance with the by-laws of said corporation, and that this Agreement is binding upon said corporation in accordance with its terms. If Tenant is a partnership or limited liability company, each individual executing this Agreement on behalf of said partnership or limited liability company, as the case may be, represents and warrants that he is duly authorized to execute and deliver this Agreement on behalf of said partnership or limited liability company, as the case may be, in accordance with the partnership agreement or operating agreement for said entity.

10. Any notice, election, communication, request or other document or demand required or permitted under this Agreement shall be in writing and shall be deemed delivered on the earlier to occur of (a) receipt, or (b) the date of delivery, refusal or nondelivery indicated on the return receipt, if deposited in a United States Postal Service Depository, postage prepaid, sent certified or registered mail, return receipt requested, or if sent via a recognized commercial courier service providing for a receipt, addressed to Tenant or Lender, as the case may be, at the following addresses:

If to Tenant:

with a copy to:

If to Lender:

with a copy to:

11. The term "Lender" as used herein includes any successor or assign of the named Lender herein, including without limitation, any co-lender at the time of making the Loan, any purchaser at a foreclosure sale and any transferee pursuant to a deed in lieu of foreclosure, and their successors and assigns, and the terms "Tenant" and "Landlord" as used herein include any successor and assign of the named Tenant and Landlord herein, respectively; provided, however, that such reference to Tenant's or Landlord's successors and assigns shall not be construed as Lender's consent to any assignment or other transfer by Tenant or Landlord.

12. If any provision of this Agreement is held to be invalid or unenforceable by a court of competent jurisdiction, such provision shall be deemed modified to the extent necessary to be enforceable, or if such modification is not practicable, such provision shall be deemed deleted from this Agreement, and the other provisions of this Agreement shall remain in full force and effect, and shall be liberally construed in favor of Lender.

13. Neither this Agreement nor any of the terms hereof may be terminated, amended, supplemented, waived or modified orally, but only by an instrument in writing executed by the party against which enforcement of the termination, amendment, supplement, waiver or modification is sought.

(NO FURTHER TEXT ON THIS PAGE)

STATE OF _____)
)ss.
COUNTY OF _____)

The foregoing instrument was acknowledged before me this ____ day of __
_____, 2007, by ***, *** of ***, Lender.

Notary Public
Stamp and/or Seal

THIS INSTRUMENT DRAFTED BY:

Mansfield Tanick & Cohen, P.A.
1700 U.S. Bank Plaza South
220 South Sixth Street
Minneapolis, Minnesota 55403-4511

EXHIBIT A

Legal Description