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Commercial Lease Pitfalls Can Snare Local Lenders

Loan Underwriters Can Demand Clauses To Avoid Defaults

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While larger lending institutions may have experience with sophisticated commercial real estate loan transactions, community or regional lenders often do not. They may not be aware of pitfalls that can arise from commercial leases which often form a significant portion of a lender's collateral package.

Care is needed when reviewing commercial leases. Here are some frequently found provisions in commercial leases that require a lender's close scrutiny:

Termination Rights An obvious concern is a tenant's right to terminate the lease which can affect a borrower's ability to meet its debt service obligations. An early termination of a lease can bring an unpleasant surprise, coupled with a loan default. A tenant's termination rights could emanate from several sources. A landlord could breach a restrictive use covenant; not complete leasehold improvements timely; not make major repairs; or not restore the premises soon enough after a casualty. Lenders should look for express termination rights, termination rights for default and the absence of appropriate language prohibiting rent off-set and possible termination.

Going Dark What are the landlord's rights if a tenant closes its doors and ceases operations? A tenant "going dark" may have nothing to do with the actions or omissions of the landlord. Although the tenant typically has the obligation to continue paying rent, collectability may be in doubt. The lender also needs to think about the potential impact a "going dark" clause has on other tenants in a multi-tenanted retail center should a tenant exercise that clause in the lease. That tenant may be the anchor on which other tenants rely heavily for traffic and business. Though landlords resist them, other tenants may have

co-tenancy clauses that allow rent reductions if an anchor tenant goes dark. A lender underwriting a loan for a landlord negotiating a lease with a "going dark" provision may insist that landlord include a right to terminate the lease in order to find a new tenant before the existing tenant stops paying rent and other tenants in the center are badly hurt.



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amount of the "set-off" or "rent abatement" is capped so that it never exceeds what is necessary to fully meet debt service, real estate taxes and insurance.

Landlord Obligation To Rebuild Or Restore The landlord typically has an obligation to rebuild or restore improvements after a casualty, depending on timing and availability of insurance. This can be a very costly undertaking for landlords, particularly if the insurance coverage is inadequate. In all cases, the lender needs to monitor the restoration process closely to help maintain the economic viability of the property, so that it continues to have the capacity to meet the lender's debt service.

Subordination, Non-disturbance And Attornment Agreements (SNDAs) The

role of the SNDA in a loan transaction is to subordinate a lease to the lender's security interest in a property. This subordination is usually given by tenants in exchange for a promise by the lender not to disturb the leasehold rights of the tenant in the event of foreclosure. However, a key provision for lenders in the SNDA is "attornment." The attornment provision stipulates that in the case of a foreclosure, the tenant will attorn to (or recognize) the lender (or the buyer at a foreclosure sale) as the new landlord under the lease, with all the same rights of the prior landlord. A new lender wants to be sure that tenants are obligated in their leases to provide an SNDA in connection with a new loan.

Estoppel Certificates Many leases provide that either party will execute an estoppel certificate upon request of the other. The estoppel gives a lender notice of existing issues in the landlord tenant relationship and any defaults by either party that might need to be cured. A lender should confirm whether the leases require tenants to provide estoppel certificates. The lender should prepare the form of estoppel certificate. Its careful review after submission by the tenant is important to confirm that there exist no unexpected issues with the property or the relationship between landlord and tenant that would prove costly to resolve by the landlord, or later by the lender if a foreclosure becomes necessary.

These are just a few of the commercial lease provisions that lenders should look for when reviewing leases. Lenders are well-advised to consult with their attorneys, since commercial leases often have a language of their own. ■

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