



By Maura B. O'Connor and Brett L. Hayes

# Caveat Lender

The due diligence of real property financing is complicated when tenant leases are involved

**I**n today's real estate market, time is the most priceless commodity. Clients, more than ever before, insist that their counsel close real estate transactions quickly and inexpensively. The result is that lawyers have less time to investigate the real property that drives these transactions. Under these circumstances, a due diligence review that misses a key fact might become a malpractice trap for the unwary lawyer.

This may be particularly true for lawyers who represent lenders financing real property loan transactions that involve tenants. When these lawyers undertake a due diligence review for their clients, they face unique problems that will be neglected unless the lawyers know what to look for during the review. The primary problem is the lender's reluctance to foreclose on the real property. Most lenders are not equipped to manage rental properties, and the last thing any lender wants to do is spend more money on foreclosed property. Thus most lenders have a lower tolerance for risk than most landlords borrowing money. Lawyers should ensure that the lender's due diligence review is expansive enough to determine:

- 1) The financial terms of the tenant leases. Lawyers should inquire whether there is sufficient cash flow to service any debt and create a profit.
- 2) The areas of the leases most likely to cause legal problems. Lenders

should know about the risks of disputes that could interrupt the flow of rents—and how and if they can limit these risks.

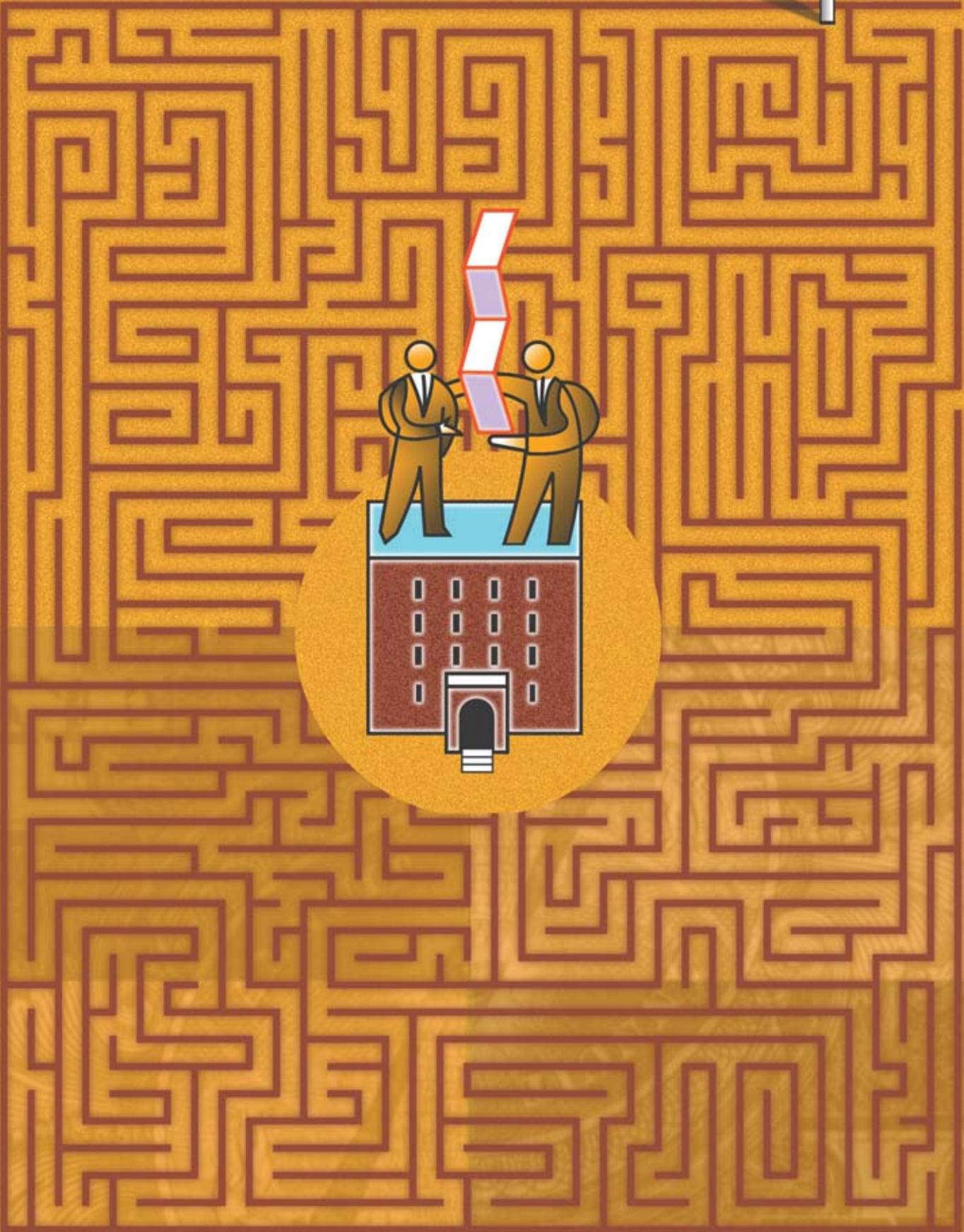
- 3) The provisions that would apply to the lender as successor landlord if it were to foreclose upon the property.

When a lender's due diligence review involves tenant leases, the lender's lawyer should review each lease, together with all lease amendments, side letters, work letters covering construction of tenant improvements (commonly referred to as TIs), and any other documents outlining the obligations of the landlord and the tenant. This review should be done as early as possible in order to correct or address any problems in the leases before the transaction closes. The documentation for the planned transaction should include representations and warranties from the current owner/landlord and the tenants. The lender or its counsel should review all parts of each lease. Ideally, the lender should also receive confirmation from the borrower/landlord in the loan documents and from each tenant in the tenant estoppel certificates that there are no oral or written under-

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*Maura B. O'Connor is a partner and Brett L. Hayes is an associate in the Los Angeles Real Estate, Land Use, and Environmental Department of Holland & Knight LLP. O'Connor and Hayes focus their practices on commercial real estate financing, acquisitions, development, and leasing.*

Beware!



Ken Coit

standings between the landlord and any tenant other than those provided to the lender in writing. (See "Tenant Estoppel Certificates," this page.)

### Basic Terms

The lawyer's review of the existing leases should cover the basic terms of each lease: the name of the tenant, the space covered by the lease, the amount of the rent, and the method by which it is calculated. In a retail lease, it is important for lenders to learn whether percentage rent (usually based on retail sales) is paid. In an office lease, lenders need to know whether the tenant must pay any other charges, such as utilities; taxes; common area maintenance (CAM) charges; heating, ventilation and air conditioning (HVAC) services during business hours or on weekends; or part of the cost for any TIs. The lawyer also typically evaluates the credit enhancements for each tenant—including lease guaranties, letters of credit, or other mechanisms that secure the tenant's obligations—to determine if there are alternative

sources of recovery for the lender if the tenant defaults.

The due diligence review should clearly identify the circumstances that allow tenants to terminate their leases. Usually lenders want leases to state that a tenant can terminate its lease only if a casualty or condemnation destroys most or all of the leased premises and the damage will not be repaired for a significant period of time. Most leases also should provide that a tenant cannot terminate its lease for reasons beyond the landlord's control. For example, a shopping center tenant should not be able to terminate its lease due to the failure of an anchor tenant to operate during required mall operating hours because the anchor tenant has filed for bankruptcy protection. The lawyer should check the insurance provisions of the leases as well to determine whether they are compatible with the casualty and condemnation provisions of the leases.

The due diligence review should also reveal whether TI allowances are provided. TI allowances are sums of money that are some-

times provided by a landlord to a tenant for the tenant's use in "building out" the tenant's premises. The use of TI allowance funds should generally be restricted to items that increase the value of the building. If TI allowances may be used for "soft" costs (such as architect's fees and permit costs), the dollar amount that can be used for these costs should be specifically stated in the lease. The amount of (or formula used to calculate) any TI allowance should be clearly stated, especially in leases for premises in which construction of the tenant's improvements is not yet complete and in future leases. When the TI allowance is based on the square footage of the premises, the lease should specify whether the reference to square footage is to total or usable square footage and should state which one of the standard methods of measuring these types of square footage was used. These methods include those of the Building Owners and Managers Association (BOMA) or the American Industrial Real Estate Association (AIR).

Ideally, counsel should review all agreements concerning brokers' commissions for all leases that are involved in the property. Before a loan is made, lender's counsel should make sure that all commissions that are due before the closing of the loan have been paid for the leases in effect. Because some commissions may have a structured payoff over a number of years, lawyers for lenders should analyze whether the payment of any future leasing commissions will adversely affect cash flow and the borrower's ability to repay the loan. In addition, the lender needs to know whether additional commissions are due if tenants expand their premises or extend the terms of their leases. Since a lender will assume the obligations of the borrower following foreclosure, a lender's lawyer should determine whether, if foreclosure were to occur, the lender would be liable for the broker's commissions.

### Valuation and Cash Flow

Once a lender's lawyer has determined all the charges that the tenants are required to pay under their leases, and all the expenses that the landlord must bear (including unpaid TIs and commissions and all concessions to the tenants), the lender's principals or underwriters can use the information to estimate the value of the property based upon the capitalization of the actual net income generated by the property. A lender usually will want its underwriters to determine whether the net cash flow from the property is sufficient for the borrower to make all payments in a timely fashion. The estimated value for the property should be compared to the appraised value of the property. If a great discrepancy

## Tenant Estoppel Certificates

**A** due diligence review by a lawyer for a lender client regarding a loan secured by real property with tenants should ensure that the lender is aware of all aspects of the tenants' leases and other agreements. The lender should secure a representation by each tenant, in the form of a tenant estoppel certificate, of the specific details of the tenant's lease, and the lender should be able to rely on the certificate when closing the transaction and in the event of any disputes. The statements in the certificate should confirm, at a minimum, all of the following:

- A true and correct copy of the lease and all amendments, side letters, and any other agreements modifying the lease are attached, and the amended lease is in full force and effect.
- The tenant has accepted the premises and is currently occupying them and paying rent and any other charges (such as operating costs and CAM costs). The certificate should contain the amount of the rent and the other charges.
- The actual commencement date of the lease.
- The square footage of the premises.
- The amount of any security deposit paid to the landlord by the tenant.
- The tenant has not paid any amounts to the landlord other than rent and the security deposit.
- The landlord has not defaulted under the lease, and the tenant knows of no action or omission that, with the giving of notice or the passage of time, or both, would become a default by the landlord.
- The tenant has no claims or defenses to enforcement of the lease, nor any right to any offsets against rent. Or, if the tenant has any such claims, defenses, or rights, the tenant must specifically list them.—**M.B.O. & B.L.H.**

exists, a lender may wish to reconsider the validity of its appraisal and the amount it is willing to lend.

To determine whether the income stream derived from the leases will support the repayment of the loan, a prudent lender will estimate the cash flow from the tenants' rent—net of all expenses—while applying a reasonable vacancy factor to account for occasional tenant attrition. This cash flow estimate should include an analysis of what would happen if certain contingencies allowed by the leases were to take place—for example, if a tenant were to exercise its option to purchase its premises or to buy out its lease for a predetermined termination fee. The estimate also may include the effect of any credit enhancements provided by the tenants. Determining the value of the property and the cash flow are usually tasks that are assumed by lenders because of their own unique underwriting requirements. Nevertheless, a savvy lender's lawyer should be intimately familiar with the lender's underwriting process in order to better advise a lender on actual versus improbable risks.

A thorough due diligence review will also disclose whether tenants have any right to self-help in the resolution of problems with the landlord. The lease, for example, may allow a tenant to set off rent against the costs of repairs or similar costs. Self-help rights have become extremely prevalent in retail leases involving anchor tenants or other sophisticated tenants, and these rights can impede cash flow in a variety of unpredictable ways. If a lender's due diligence discloses these rights, then the lender could craft a resolution with the borrower precluding the enforcement of these remedies against the lender after a foreclosure.

The review also should disclose whether an original tenant is automatically released from liability for payment under its lease if it assigns its lease to a third party. Most lenders object to such a provision because they want as many creditworthy parties on the hook as possible.

Another important issue is whether the leases are structured so that inflation is not likely to diminish their profitability. Some leases provide that rents may increase by a set amount over time, or that rents may be adjusted by the increase in the Consumer Price Index or some similar formula. Some leases adjust the rents to estimated market rates by means of dueling appraisals or through arbitration. A careful lawyer will also check to make sure that CAM costs and other operating costs that the tenant is required to pay are adjusted for inflation.

If one or two large tenants are involved in the property, the lender needs to consider



whether the cash flow from the property will be severely diminished if those key tenants leave. If anchor tenants have the right to terminate their leases upon payment of a fee or by exercising an option to purchase the property, the size of the fee or purchase price should be considered. In addition, some lenders require that all lease termination fees be paid directly to them instead of to the borrower/landlord. If a tenant has an option to purchase the property, most lenders will insist that the option price be equal to at least the unpaid balance of the mortgage (plus any senior liens) at the time of purchase, and that the mortgage be paid in full when the option price is paid. Again, the familiarity of lawyers with their lender clients' underwriting requirements will help the lawyers identify these economic concerns and advise their clients about them earlier rather than later in the transaction.

### **Exclusive Use Clauses**

As part of the due diligence analysis, lenders' lawyers should be aware of any exclusive use clauses in tenants' leases. Tenants with these clauses could have conflicting rights. From a lender's perspective, exclusive use clauses can be troublesome because they limit lease activity, increase the likelihood that a tenant may terminate the lease, and potentially limit the lender's ability to lease space to competing tenants in other nearby properties owned by the lender.

The pitfalls associated with exclusive use clauses are boundless. Therefore, a lender's lawyer should be intimately familiar with all exclusive use provisions and should correct any shortcomings in the clauses prior to the close of any loan transaction.

Lenders' lawyers must assess whether

the exclusive use clause is "business-oriented" or "product-oriented." A narrowly drawn business-oriented exclusive use clause is limited in scope and does little to restrain competition between tenants. For example, if an exclusive use clause has been granted to a tenant to operate an office supply store, tenants operating a computer store or business furniture store in the same shopping center would not violate the first tenant's exclusive use clause.

Alternatively, a product-oriented exclusive use clause curbs competition because it specifically identifies products that other tenants cannot sell. The problem with product-oriented exclusives is that they place a significant burden on landlords to continuously supervise and monitor their tenants. For example, in a California case involving a drug store, the landlord promised its drug store tenant that no other store would be permitted to sell drugs, medicines, or cosmetics in the shopping center.<sup>1</sup> A supermarket tenant subsequently began to sell these types of products. The landlord argued that it relied on the supermarket to work out its differences with the drug store tenant. But the court held that the landlord could not avoid its obligation under the lease by seeking to delegate its performance to others.

Ideally, the lawyer's review of the leases should be used as a base from which to obtain tenant estoppel certificates, which are detailed representations about the leases typically prepared by buyer's or lender's counsel for review and execution by each of the tenants of a property. A certificate should expressly provide that in closing the contemplated transaction, the buyer or lender and its counsel will rely on the statements in the certificate. If a tenant signs such an estoppel, it cannot later

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### Foreclosure Issues

While lawyers need to conduct their due diligence review against the backdrop of knowing that lenders seek to avoid foreclosure, lawyers still must evaluate whether the leases of the property at issue would be acceptable to the lender if the lender were to foreclose on the property and step into the shoes of the landlord.

Typically, a lender's lawyer will analyze the financial terms of the leases with the lender, considering which agreements of the original landlord would be so burdensome to the lender after a foreclosure that the lender would not be willing to be bound to them. Some of the types of agreements that might be overly burdensome include:

- An agreement by the landlord to provide or finance a TI allowance to the tenant or to build TIs for any expansion space.
- An agreement allowing a tenant to use the premises without paying rent during certain periods. (These periods usually occur early in the term of the lease, but agreements sometimes provide for rent-free periods at other times during the term.)
- An agreement by a landlord to pay the obligations of its tenant under the lease at a different location (usually the tenant's former premises).

The object of this review is to identify obligations that the lender is not willing to assume, so that the lender's counsel can draft appropriate Subordination, Nondisturbance and Attornment agreements (SNDAs) in which the lender is absolved from liability for those obligations if it forecloses.<sup>2</sup>

A key question that the lender's lawyer will need to answer in advance is whether the leases will survive a foreclosure. The black letter law of real estate priorities is "first in time, first in right," meaning that a mortgage (or deed of trust) recorded in the public records after the recordation of a notice or memorandum of lease is junior in priority to the lease. If a memorandum or notice of a lease is recorded after a mortgage is recorded, the lease is generally junior to the mortgage.

Many leases contain subordination clauses that may not work to a lender's advantage. Automatic subordination clauses are provisions that make the tenant's lease automatically junior to any lender's mortgage. Such provisions can be dangerous for lenders to accept, because they are often too broadly drafted. For example, such a clause can make a tenant's lease junior in priority, or subordinate, to *all* mortgages, including junior financing. From the senior lender's position, this could lead to an unpleasant situation in which

a junior lender that forecloses its mortgage could extinguish leases that the senior lender would prefer to keep in place. For these reasons, any lender that accepts an automatic subordination clause in leases should make sure that the clause operates only to subordinate the lease to its own mortgage.

With each important tenant, it is prudent to enter into an SNDA that provides contractually that the tenant's lease will remain effective after a foreclosure by the lender. Without an SNDA, it can be difficult to predict whether, after a foreclosure, the lender or other purchaser of the foreclosed property will be entitled to enforce the leases.

Typically, if a mortgage junior to a lease is foreclosed, the lease remains in effect and the purchaser at the foreclosure sale (usually the foreclosing lender) takes title to the property subject to the lease terms. If a mortgage senior to a lease is foreclosed, under California law the junior lease usually is terminated by the foreclosure, the tenant is no longer obligated under the lease, and the purchaser at foreclosure gets title to the property—but risks losing the tenants. In some states, however, including California, tenants in possession when the loan is made may have certain rights, even if their leases are not recorded and are therefore junior to the foreclosed mortgage, but the obligations of the

purchaser as successor landlord may not be clear.<sup>3</sup>

In California, although case law is rather muddled and may result in unexpected consequences, the general rule is that a lease that is subordinate to a deed of trust is extinguished by foreclosure of the deed of trust.<sup>4</sup> Since using an SNDA both creates a more predictable outcome and protects foreclosing lenders by ensuring that the existing leases will be enforced after a foreclosure even in a falling rental market, most lenders should use SNDAs to limit their risks.

If the review of a lease discloses major problems that are so severe that a carefully drafted tenant estoppel certificate alone will not fix them, the lender's lawyer should recommend that the lender ask its borrower, the landlord, to resolve all those lease issues by use of either an SNDA or an amendment to the lease. The extent to which a lender can obtain the agreement of a tenant to resolve the ambiguities and problems caused by the lease depends upon the bargaining power of the lender, landlord, and tenant.

Alternatively, the lender and the tenant can agree, in an SNDA or in a separate contract, that certain obligations and promises of the original landlord will not be binding upon the lender if it forecloses on the property. Lenders' lawyers may require representa-

tions and warranties from the borrower concerning the performance of its obligations as landlord, including the borrower's confirmation that it is not in default in its obligations as landlord under the leases, and the borrower's express promises to perform its obligations as landlord under the leases.

There is no magic to due diligence. It is, in many respects, a thankless job. Nevertheless, if done properly, the service provided to clients is invaluable, not to mention one that they genuinely appreciate in the end. Although time may be in short supply for real property transactions, conducting a sound and thorough due diligence review will help most lawyers sleep soundly through the night after their deals have closed. ■

<sup>1</sup> Hildebrand v. Stonecrest Corp., 174 Cal. App. 2d 158 (1959).

<sup>2</sup> See, e.g., David P. Kassoy, *The Tension Between Lenders and Credit Tenants over SNDAs*, LOS ANGELES LAWYER, Jan. 2001, at 16.

<sup>3</sup> See Morton P. Fisher Jr. & Richard H. Goldman, *The Ritual Dance Between Lessee and Lender—Subordination, Nondisturbance, and Attornment*, 30 REAL PROP. PROB. & TR. J. 364, 376 *et seq.* (Fall 1995).

<sup>4</sup> *Dover Mobile Estates v. Fiber Form Prods., Inc.*, 220 Cal. App. 3d 1494 (1990). *But see* *Miscione v. Barton Dev. Co.*, 52 Cal. App. 4th 1320 (1997) (contradicting *Dover* because it suggests that a lease subordinate to a loan is not extinguished if an attornment clause is in place).

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