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INSIDE:

The Year of the Fed
page 4

**Commercial Real Estate Lending:
Lease Review in Troubled Times**
page 9



Commercial Real Estate Lending: Lease Review in Troubled Times

Every banker is keenly aware of the effects of the economic downturn of 2009 on the access to credit for commercial real estate developers and projects. Economists predict that the new year will not usher in significantly different times.

In considering loans secured by multi-tenant income-producing property, such as an office building or shopping center, lenders have become more sensitive to the quality of the borrower's lease agreements with its tenants.

When underwriting a loan for commercial property, a thorough review of all leases affecting the property is critical, since the income streams generated by the leases will be the primary source of funds for debt service. Additionally, bankers realize that today's real property collateral may easily become tomorrow's REO asset, so a thorough review is required to understand potential future responsibilities in the event that the bank acquires title to the property. Although the specific type of lease and project generally dictate areas of concern, the following guidelines should uniformly be considered during any lease review.

Know the Basics

Prior to reviewing the substantive provisions of any lease, the banker should first become familiar with the basics of the lease and the project.

First, understand the project. By confirming the location of the project, type of project (e.g., office, retail, industrial), and number and mix of tenants, the bank can streamline its review by identifying critical issues specific to the particular project.

Second, obtain all documents. The banker should verify that the lease is fully executed and contains all exhibits, riders, and schedules, and should obtain complete copies of all amendments and any ancillary documents, such as guaranty agreements or commencement date agreements.

Third, confirm the parties. The banker should confirm that the legal

names of landlord, tenant and guarantor, if applicable, are used in the lease, that the parties are in existence and in good standing in their state of formation, and, to the extent formed in a state other than where the property is located, that the parties are authorized to do business in such state.

Review the Lease as Part of the Collateral

To understand the reliability of the income stream presented from the leases, banks need to examine, at a minimum, the following components of the lease:

The Tenant and its Financial Capacity. The bank must evaluate the creditworthiness of the tenant. As part of this analysis, the banker should confirm (a) the type of tenant (e.g., individual, single purpose entity, parent or other party related to the borrower) and (b) whether the lease has been guaranteed and if there are other credit enhancements such as letters of credit, security deposits, or prepaid rents or CAM charges. If the lease has been guaranteed, the banker should also con-

■ Lease Review - continued on page 13

■ Lease Review - continued from page 10

firm (i) the type of guarantor (e.g. individual, parent or other party related to the borrower), (ii) whether the guarantee is full or limited, and (iii) whether the guarantor can be released from the guarantee prior to the end of the lease term.

Right to Assign and Sublet. Once the bank understands the creditworthiness of the tenant, the banker must consider the tenant's ability to exit the lease by assigning its rights under the lease or subletting the premises. In the event the lease permits the tenant to assign and/or sublet, the banker should confirm whether the lease limits these rights based upon the financial viability, reputation, and type of business of the proposed assignee or sublessee, and whether the tenant remains liable on the lease after the transfer to the proposed assignee or sublessee.

The Term and Tenant's Rights to Extend, Terminate and Purchase. The term of the lease and the tenant's ability to extend and/or terminate the term heavily influence the income stream. The value of a lease increases as the length of the initial term increases. Extension options should be considered, but not given much weight, since a tenant is generally not obligated to extend. Extension options should be reviewed, however, to determine the rent terms for the renewal period. Ideally, rent for any extension period will be the fair market rental rate versus a predetermined rate that may not account for inflation. Termination rights should also be examined. Tenant termination rights often arise upon condemnation or destruction of the project, failure of landlord to complete a construction obligation or reimburse tenant for a monetary obligation within the time frame set forth in the lease, failure of landlord to provide essential services such as utilities for a specified time period, and/or loss of an anchor tenant. The banker should also view any option to purchase as an effective termination right since the term of the lease will end if the option is exercised. Additionally, if the bank has notice of a tenant's option to purchase and the lease granting such option is prior and not subordinate to the deed of trust, the property may be acquired free of the liens securing the bank's loan.

The Rent and Tenant's Rights to Abate and Offset. Rent is generally the most important provision in the lease. The banker must confirm the effective rent rates for the term of the lease by examining free rent periods, tenant improvement allowances, services provided by landlord without charge, and any other inducements to the tenant that would affect rent. Secondly, the banker should evaluate the consistency of the rent stream by taking note of all lease provisions that permit the tenant to abate or offset rent (e.g., upon default by landlord, loss of one or more anchor tenants, exercise of tenant's self-help rights).

Review the Lease as Part of the REO Asset

In addition to reviewing a lease for its value as loan collateral and project net operating income, banks should place equal importance on reviewing the lease as part of a potential

REO asset in the event the bank acquires title to the property. This review requires the bank to identify the liabilities and obligations for which they may be responsible if they take title to the project and the affect of such liabilities and obligations on the future marketability of the project. The banker should carefully consider, at a minimum, the following components of the lease, each of which may result in open-ended monetary obligations or unquantifiable risks for the bank which would need to be addressed and resolved in an estoppel certificate and subordination, non-disturbance and attornment agreement with the tenant:

Construction Obligations. The landlord's construction obligations should be reviewed along with tenant's rights and remedies upon the landlord's failure to complete these obligations. Most banks are reticent to obligate themselves to complete construction of the project since they are not well equipped to manage even smaller building projects. There is also the risk of patent or latent defects in construction of the project. In addition, most leases include provisions regarding the construction of tenant improvements. Often, the tenant is required to complete the work, but will be reimbursed by landlord with a tenant improvement allowance upon satisfying certain conditions. On occasion, however, the landlord is required to complete the work at its sole cost. To understand the bank's potential liability once it acquires the project, the banker must know the party obligated to completing the work and by what date, the cost of the work, who is paying for the work, and who is liable for any post-construction improvements and maintenance.

Environmental Liabilities. The banker must review the environmental provisions in the lease and the responsibilities of each party in the event an environmental issue arises. Most importantly, the banker should evaluate the sufficiency of provisions requiring tenant to indemnify landlord for tenant's failure to comply with laws regarding the storage, use, and disposal of hazardous substances, and whether such provisions survive expiration or earlier termination of the lease.

Landlord Liability. The banker should verify that the lease includes a provision limiting the liability of the landlord to its equity interest in the project and solely to those issues arising during its period of ownership.

This article is not a comprehensive outline of all lease-related issues affecting commercial real estate loans, and in particular, does not address the unique issues that arise with ground leases and the related leasehold estates. However, many key components are addressed that should be given additional time and consideration when reviewing a lease in the current economic climate.

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