Lenders and Leases: Important Legal Issues

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Financial institutions that make loans on commercial real estate frequently have to contend with issues pertaining to commercial leases. Aside from the underwriting issues, there are numerous legal issues that can arise in connection with such loans. The issues are very different depending on whether the borrower is the landlord or the tenant.

When lending to the landlord, the bank will want to be assured that the revenue from the lease(s) is part of the bank's collateral. Fortunately, this is not an issue under Nevada law. Most deeds of trust will include an assignment of leases and rents, and occasionally the loan documents will include a separate assignment of leases and rents (which is not necessary in Nevada). Even if the loan documents are completely silent on the assignment of rents, the Uniform Assignment of Rents Act which Nevada enacted in 2007 provides that any deed of trust automatically includes an assignment of rents of the property. This Act also includes a variety of rights and remedies for the lender as assignee of rents.

If the borrower is the landlord, the lender should generally obtain a subordination, non-disturbance and attornment agreement (SNDA) from major credit tenants to assure that the lease will remain in effect following any foreclosure on the property. Conceptually, this agreement has three components: (1) Subordination: the lease is subordinated to the deed of trust. (2) Non-disturbance: the lender agrees not to disturb the tenant in its occupancy of the premises if the lender forecloses and the tenant is in compliance with the lease. (3) Attornment: the tenant agrees to attorn, or recognize the lender as the new landlord, if the lender forecloses.

It is not necessarily a good practice to obtain SNDAs from all tenants in all cases, however. The lender should use its business judgment in deciding whether or not an SNDA is necessary or advisable. For example, an SNDA has little value if the tenant is occupying its premises on a month to month or short term lease, which will expire or can be terminated even if the tenant agrees to an SNDA. Further, an SNDA may have little practical value when the tenant's rent does not contribute significantly to the underwriting of the loan. Requiring SNDAs from all tenants in a retail or office center may also create an undue administrative burden in tracking down and obtaining tenant signatures and negotiating any requested changes to the lender's form of agreement.

Additionally, the lender should think carefully about entering into an SNDA with a tenant that is affiliated with the borrower. If the lender forecloses on the property after a borrower's default, the lender will not want to have a contractual obligation to keep the borrower affiliate as a tenant. In this situation, the lender should require a subordination agreement, which allows the lease to be terminated upon foreclosure, without the non-disturbance and attornment components.

While many tenants may not be familiar with the concept of an SNDA, major national tenants will often require an SNDA (before or after closing of the loan) in order to protect their own interests as tenants. Such tenants, which are most likely to offer significant credit support for the loan, generally have their own SNDA form and may not be willing to negotiate any changes.

Alternatively, if the borrower is the tenant under a ground, normal office, or retail lease, different issues arise. A leasehold deed of trust with a power of sale is the appropriate vehicle in Nevada for obtaining a security interest in the tenant's interest under a lease. This deed of trust is recorded in the official real estate records of the county. This is preferable to an assignment of the lease because an assignment of lease without a power of sale has to be foreclosed by filing a legal action in court, while the power of sale allows a deed of trust to be enforced through the non-judicial foreclosure process. Recording is necessary to make the security interest in the lease binding on third parties.

It is important to remember that in this situation the lender's collateral is the tenant's interest under the lease, not the property itself. The economic value of the lease as collateral will depend on numerous factors, such as the term of the lease, whether the rent is above or below market, and (in the case of a ground lease) the value of the improvements. If the lease prohibits an assignment or encumbrance by the tenant, the lender must obtain the landlord's consent. The lender should also obtain an estoppel certificate from the landlord, certifying that there is no default under the lease, rent is current, and other related matters.

Sometimes a lender will make a loan to a borrower that is a tenant at numerous locations, such as a franchisee of a fast food operation. While there may be some benefit to obtaining a leasehold deed of trust for each location, the administrative burden of obtaining these deeds of trust for numerous locations, with the consents of multiple different landlords, should be weighed against the benefit to be derived from obtaining the leases as collateral.

Another issue that may arise when a financial institution is making a loan to a tenant secured by personal property of the tenant is whether the lender has the right to enter on the premises to remove the personal property collateral if the loan goes into default. Normally, the lender, not being a party to the lease, would not necessarily have the right to enter and remove the collateral. Therefore the lender should obtain the landlord's consent to removal of the collateral and also waiver or subordination of any lien that the landlord may have in the same collateral.