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IN THE SPOTLIGHT

Leasehold Financing: It's Good to Have Options

Including a Lender's Baseline Requirements for A Lease to be Financeable In a Ground Lease

By Jay Melnick

Let's face it — we all like instant gratification. However, as current market conditions force us to sober up from years of economic over-indulgence, there is a need to discard those practices that may previously have seemed perfectly reasonable. It is now clear that these practices were not in fact properly thought-out or sufficiently disciplined to provide for true long-term stability or future success. This article discusses one particular concept in commercial leasing, which, if properly addressed and negotiated up front, is likely to benefit both the landlord and the tenant by providing greater security and increased credit possibilities in the years to come — namely, leasehold financing.

Leashold Financing and What It Is

Leasehold financing is secured by a mortgage on the tenant's interest under a lease. As with fee-based financing, the lender in a leasehold financing transaction will record a mortgage or deed of trust against the collateral property, but in the case of leasehold financing, should the

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Tax Issues for Real Estate Leasing by Tax-Exempt Organizations

Developing and Leasing Vacant Land

By Michael J. Huft

The first article in this series, published in March 2009, examined the issues involved when a tax-exempt organization leases improved property to one or more parties, for example a research building owned by a university leased to one or more private businesses. The primary issue examined in that article was whether or not the lease payments to the university constituted, in whole or in part, payments for services provided to the tenants, rather than purely payments for the rental of real property.

The article herein examines the issues involved when a tax-exempt organization owns a tract of vacant land that it wishes to develop and lease, so as to realize a stream of income from the land greater than would be realized by a simple sale or lease of the unimproved property. The third and final article in this series will examine the special cautions that must be observed if the real estate is debt-financed.

Review of UBIT

As described more fully in the earlier article, the federal tax code imposes a tax (referred to as the unrelated business income tax, or "UBIT"), computed at the corporate income tax rate, on the unrelated business taxable income ("UBTI") of most exempt organizations. An unrelated business is any trade or business, the conduct of which is not substantially related to the performance by such organization of the functions that constitute the basis of its exemption from tax. The tax code provides for the categorical exclusion from UBTI of income from certain enumerated sources or arising from certain activities, including all rents from real property, provided that the determination of the amount of such rent does not depend in whole or in part on the net income or profits derived by any person from the property leased.

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Tax-Exempt Issues

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Avoiding Participation in Development

The basic problem to be resolved when a tax-exempt organization desires to develop and lease vacant land for reasons other than its exempt purposes is that this involves two separate activities: 1) developing the property; and 2) leasing the property.

Whereas income from leasing the property (in the form of rent) is generally excluded from UBTI, the activity of developing the property is considered to be an unrelated business, and the income attributable to that activity is, therefore, taxable to the organization. Although an exempt organization rarely acts as a developer itself, it frequently enters into a relationship with a professional developer to improve the property. Therefore, it is important to structure the relationship between the exempt organization and the developer appropriately. A joint venture or partnership (including a limited liability company taxed as a partnership) between the developer and the tax-exempt landowner, which is often used by non-exempt landowners to develop and lease property, will not work in the case of a tax-exempt landowner. Since the net income, or profits, of a partnership are attributed pro rata to the partners, and since the IRS deems the right to receive a share of the profits to be equivalent to participation in the activity giving rise to the profits, regardless of any actual physical involvement, the portion of the profits allocable to the exempt entity will be treated as taxable income from the unrelated business of developing real estate.

Use of Ground Lease With Appropriate Rental Formulas

The most frequent alternative that is used by tax-exempt organizations to avoid UBTI in the development and leasing of land is a ground lease, whereby the organization leases the property to a developer, which will then develop the property (often involving subdivision) and sublease the parcels to the ultimate tenants. Because the whole purpose for developing the property is frequently so that the exempt organization can realize a greater return from rentals than it would from simply leasing or selling the vacant land, the rental terms in the ground lease are frequently complex so that the rental income will approximate what the organization would have received as its share of the profits under a joint venture with the developer. For example, in addition to a flat base rental amount each year, the lease may include additional rental amounts based on a calculation of completed square footage of improvements and/or a percentage of gross revenues received by the developer from the ultimate tenants ("percentage rent"), often reduced by certain expenditures of such tenants, including maintenance charges for common areas, taxes and other assessments, or similar amounts. Furthermore, the lease may designate certain dates on which the base rent will increase, either by an amount fixed or calculable under the lease, or to be renegotiated by the parties by agreement or appraisal.

As mentioned above, the most frequent alternative that is used by tax-exempt organizations to avoid UBTI in the development and leasing of land is a ground lease, whereby the organization leases the property to a developer, which will then develop the property (often involving subdivision) and sublease the parcels to the ultimate tenants. It is important to take care in drafting a ground lease, however, since the subtractions from percentage rent for costs realized by the ultimate tenants could make what started out as rent based on gross proceeds look very much like rent based on net income or profits, even if not so expressed in the lease. Even if an agreement is called a lease, and the payments are all termed "rent,"

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Leasehold Financing

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borrower default on the loan, the lender's primary remedy will be to "foreclose" on the leasehold mortgage by stepping into the borrower's shoes and becoming the tenant under the lease.

There are several scenarios in which a lender might accept a mortgage of a tenant's interest under a lease as security for a loan. Probably the most common of these is if the rent payable under the lease has not kept up with market rates, creating a "windfall" value for the holder of the tenant's interest. Similarly, if a tenant under a ground lease for unimproved property has subsequently constructed improvements (which under a "true" ground lease, will typically belong to the tenant), not only will the improvements themselves be valuable to a lender as collateral for the loan, but depending on the assignment and subleasing provisions of the lease, the improvements might also have created additional value by increasing the amount of rent that an outside party would reasonably be expected to pay.

In the alternative, it is possible that the leasehold interest might not have any significant inherent value to lenders in general but might nevertheless be attractive to a certain "niche" lender, such as a preferred lender for a particular franchisor, with whom the lender has an ongoing business relationship and with respect to which franchise the lender has specialized experience and operational knowledge. Finally, it may be the case that the leasehold interest itself does not have significant value at all, but the lender has made a business decision to accept it as loan collateral based on the value of the tenant's personal property, a personal guaranty, or other such considerations.

As with any loan, the lender in a leasehold financing transaction will need to exercise a certain degree of oversight and control over the collateral to ensure that the value of that collateral is not impaired. While this will be accomplished primarily by means of various covenants, representations, and warranties in the loan documents, because the lease is a contractual arrangement between the tenant and the landlord, there are several fundamental assurances that will inevitably require the landlord's consent. The most common of these, and from the lender's perspective, the most important, include the following.

Nondisturbance by Creditor In Possession of Fee

To the extent the landlord has mortgaged the fee interest in the leased property as security for financing of its own, the leasehold mortgagee will need to feel comfortable that, should the landlord default on its loan and the landlord's mortgagee take possession of the property, the mortgagee in possession will not be able to terminate the lease or vacate the tenant and thereby destroy the value of the leasehold mortgagee's collateral. This will most likely be accomplished by a recorded nondisturbance agreement in favor of the tenant (typically included in a subordination, non-disturbance, and attornment agreement or "SNDA"). Ideally, the nondisturbance agreement should inure to the benefit of the tenant's successor and assigns, but if the agreement is already of record and does not so state, then depending upon the circumstances, the lender on the leasehold estate may or may not require a new agreement. Moreover, because the leasehold mortgage will run parallel to the fee mortgage and encumber a completely different piece of collateral, the landlord does not need to worry that the existence of the leasehold mortgage will adversely affect its obligations to the holder of the fee mortgage.

Landlord Acknowledgment/ Acceptance of Leasehold Financing and Tenant's Right to Assign to Leasehold Mortgagee

Inherent in the concept of leasehold financing is that the lender will need to know that it can exercise its foreclosure remedy without having to deal with the landlord. Specifically, this means that the landlord will need to have agreed to the assignment by the tenant of the tenant's interest under the lease. While a landlord might consider its customary agreement to "reasonable" consent to assignment by the tenant to be sufficiently accommodating, in the leasehold financing context, any landlord consent requirement whatsoever will prevent the lease from being financeable. This is because (even assuming that the lender can record its mortgage and have it insured by the title company), if there is a possibility that the lender will be required to obtain the landlord's consent in order to foreclose, the landlord would then have a hold-up right over the lender, the cost of which risk would be difficult or impossible for the lender to quantify at the time the loan is made. Nevertheless, it is perfectly reasonable and justifiable for the landlord to clarify that the assignment will not create any additional rights in favor of the tenant or impose any additional obligations on the landlord beyond those already contained in the lease. Furthermore, depending on controlling successor liability law, the business terms of the transaction, and other such considerations, the landlord may convince the lender to assume the obligations and/or cure the defaults of the prior tenant as well.

Leasehold Mortgagee Notice and Cure Rights With Respect to Defaults By Tenant Under the Lease

Just as a lender on a fee interest will typically reserve the right to pay taxes or other amounts on behalf of the borrower in order to prevent the value of the collateral from becoming impaired, the lender on a leasehold estate will need to know that, should the borrower become delinquent and/or default in its obligations to the landlord under the lease, the lender will be able to cure such deficiencies and preserve the value of its collateral. Since the

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Leasehold Financing

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leasehold mortgagee will only be able to cure those deficiencies of which it has knowledge, the landlord will also have to agree to give the lender notice of such deficiencies. Generally speaking, however, the lender would be hard-pressed to justify a request for any notice and cure rights in excess of what the landlord has given to the tenant under the lease, and it is not unreasonable for the landlord to put the burden onto the lender to notify the landlord in writing of any future address changes. Thus, while important to the lender, the particular leasehold financing requirement should not be especially onerous for the landlord.

Consent of Leasehold Mortgagee Required to Modify Lease Terms

Since the lender will have underwritten the transaction based on the terms and conditions of the lease as they existed at the time of the loan, the lender will want to be comfortable that the landlord and the tenant will not be able to alter those terms and conditions in a way that would jeopardize the value of the leasehold estate as collateral for the loan. A "good" leasehold financing provision, from the lender's perspective, might require the landlord to agree that the lease will not be modified, amended, terminated, or altered in any way, and that the landlord will not, without the lender's consent, terminate the lease or accept a surrender of the premises. Since the lender will already have gotten these protections from the borrower in the loan documents, the only situation in which the lender would need to rely on the cooperation of the landlord would be if things go so severely awry between the lender and the borrower that the borrower becomes completely uncooperative. Therefore, depending on the facts of the particular situation, the landlord may have a good argument that a provision which subjects all lease modifications to the lender's consent is overly broad. Indeed, as the financial climate changes and lenders are able to charge more for their services but are, in return, required to bear the risk of the loan themselves (as opposed to acting simply as intermediaries who pass that risk onto someone else), the strength of this argument by the landlord should increase. The landlord, therefore, may request that the provision be deleted in its entirety, or at the very least, that it be limited in its scope so as to apply only to lease modifications that materially and adversely affect the value of the lender's collateral.

Right of Leasehold Mortgagee to Exercise Any Extension or Similar Options in Favor of Tenant

Finally, the lender would ideally want to have the right, even prior to assuming the tenant's interest under the lease, to exercise any extension options (or options to purchase, etc.) on behalf of the tenant under the lease. Since much (or most) of the potential length of a ground lease will typically be in the form of extension options, having less-than-perfect certainty that those options will be exercised could create a significant underwriting risk for the lender. A landlord who is worried about getting in the middle of a dispute between the tenant and the lender and who is, therefore, reluctant to grant such a right to the lender should rely on the same argument described above with respect to amendments and modifications to the lease. In other words, it is the lender who is (or should be!) in the business of evaluating risk and who will be monetarily compensated for accepting such risk. Thus, the fact that not being able to exercise the options on behalf of the tenant creates a certain risk for the lender is the lender's problem — not the landlord's. Again, the outcome of this argument will hinge on the particular circumstances, such as the timing of the extension options relative to the length of the loan, the value of the particular leasehold interest in question as part of the entire package of collateral, and the lender's overall confidence in the borrower as a credit risk.

Conclusion

As stated above, it is best to address these key items in a leasehold financing provision in the original lease. While the absence of such a provision will not necessarily preclude the tenant from obtaining leasehold financing, it will require the tenant to go back to the landlord and obtain the rights necessary for leasehold financing in an estoppel, a lease amendment, or the like. To the extent such negotiations are required at the time the loan is made, they are likely to involve significant transaction costs and inconvenience and might even render the transaction as a whole too expensive to be feasible. If, on the other hand, the leasehold financing rights are clearly set forth in the original lease, the parties should be able to avoid the vast majority of such costs and inconvenience and accomplish the leasehold financing transaction smoothly and efficiently.

Finally, it is worth mentioning that even if the lease does contain a proper leasehold financing provision, the lender most likely will still need the landlord to deliver an estoppel similar to what one might see in connection with a fee interest financing or purchase and sale transaction, in which the landlord confirms the basic lease terms, that all amounts owed by the tenant under the lease have been paid, etc. Hopefully, if the lease contains a good leasehold financing provision, the landlord's estoppel obligations will be clearly described as well — but regardless, the landlord should keep in mind that in some ways its interests are parallel to those of the tenant.

For one thing, the landlord benefits by knowing that a lender that has just conducted its due diligence review has found the tenant to be an acceptable credit risk. Secondly, should the tenant default, having a "backup" tenant available means

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Bridging the Gap Between Leasing and Loan Transactions

By Steven L. Rosenfeld

Lease documents are often negotiated without sufficiently considering: 1) the effect that certain lease provisions may have on future financings; and/or 2) the lease approval requirements in existing loan documents. Also, loan documents are often negotiated without sufficiently considering how some of the loan provisions will affect the owner's future leasing activities. These problems can be exacerbated when different attorneys (and potentially different business people) are responsible for negotiating the leasing documents and the loan documents without sufficient coordination. This article seeks to address how lawyers representing owners in negotiating leases and/or loan documents can help bridge these gaps.

Financing Considerations in Leasing Transactions

Underwriting

Loan underwriting for income producing properties usually takes into account the occupancy rate, the lease terms and the existing and anticipated cash flow from the property. Therefore, leases that provide for below market rents or free/abated rent periods or that allow tenants to go dark or terminate for any reason (other than pursuant to the casualty and condemnation provisions) can negatively impact loan underwriting.

Also, it often is preferable that leases have staggered expiration dates. If most of the leases expire about the same time, lenders will be concerned about the vacancy/re-tenanting risk and cost (if the leases expire during the loan term), or the refinancing risk (if the leases expire near the loan maturity date). To mitigate these risks, lenders may: 1) value the property at a lower amount; 2) reduce the loan term such that the loan matures prior to the expiration of the leases; 3) require a holdback of loan proceeds and/or the monthly funding of a tenant improvements/rollover reserve to pay for the future re-tenancy costs; 4) require additional collateral such as a letter of credit or guaranty; and/or 5) require, for a certain period prior to the expiration of the lease(s), that all excess cash flow be swept into a lender account.

Assignment and Subletting

Since lenders take into account the identities and financial strength of the tenants, leases should include restrictions on assignment and subletting, including those relating to the financial strength of the assignee (and to a lesser extent the subtenant), and provisions to assure that the initial tenant and any guarantor remains liable in the event of any assignment or sublease.

Subordination and Attornment

From a lender's perspective, a lease should provide that: 1) it is automatically subordinate to any loan document currently encumbering the property or subsequently entered into (unless the lender elects otherwise); and 2) the tenant will automatically attorn to a lender that acquires the property either by foreclosure or deed-in-lieu. Having such a provision in a lease may reduce the likelihood that, in connection with a financing, the lender will require a subordination and non-disturbance agreement (an "SNDA") from the tenant, which is a real advantage given the time such documents often require to negotiate. However, most sophisticated tenants with leverage will require that non-disturbance be a condition to such subordination and attornment. In such event, the subordination should be conditioned upon the tenant and lender entering into an SNDA in a commercially reasonable form typically used by the lender. If the use of the lender's form is not satisfactory to the tenant, compromise approaches include reference to a mutually satisfactory commercially reasonable form (which puts off negotiations and potential disputes to another day) or attaching a form to the lease that is negotiated to reflect the landlord's best guess as to its future lender's requirements (which has the disadvantage of prolonging negotiations without providing any real comfort that the form will be acceptable to a future lender). Many national tenants have their own form of SNDA that they will not negotiate with the landlord; if so, the only alternative may be to agree to use the tenant's form and hope that the tenant will negotiate with the lender at a later time.

Rights of First Offer/Refusal and Purchase Options

If rights of first offer/refusal or other purchase options need to be granted, then such rights should be subordinate to the rights of any current and future lender. Such subordination may protect a lender from the potential risk of having its lien on the property wiped out upon the exercise of such rights. From a lender's perspective, try to get this subordination to be absolute (*i.e.*, tenant's right of first offer/refusal or other purchase option will be wiped out by any foreclosure or deed in lieu). If not, a good compromise is to provide that the right will not affect any foreclosure or deed-in-lieu or the first sale of such property after foreclosure or deed-in-lieu, but will thereafter spring back into effect. It is best to get these lender protections in the lease at the time such rights are granted, as it can be very difficult and costly to get these protections from the tenant at a later time.

Lease Approval Rights

In connection with every leasing transaction, the existing loan documents should be reviewed: 1) to ascertain whether the lender's consent to such transaction is required; and 2) if such consent is required, to understand the process of obtaining the lender's consent. Failure to comply with the leasing approval requirements could cause the owner to be in default under the loan documents.

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Bridging the Gap

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Insurance, Casualty and Condemnation Provisions

The insurance requirements in leases should be made consistent with the landlord's insurance obligations under the existing loan documents. Also, the landlord's obligations under the leases to repair and restore the premises and for holding and disbursing insurance proceeds/condemnation awards should be consistent with the casualty/condemnation provisions in the existing loan documents. If the tenant is responsible for maintaining insurance for the real property and improvements, the landlord should require that its lender be named as an additional insured, as lenders will typically require this.

Loan Document Provisions That Affect Leasing

Lease Approval

Most loan documents provide that the borrower may not enter into certain leases without the consent of the lender. Such consent rights should normally apply only to retail, office, industrial and other commercial leases, and not to any residential lease, storage lease or any occupancy by a hotel guest.

The lender's consent is typically required for "Major Leases," which are usually defined as leases that exceed a certain size threshold (*e.g.*, any lease for more than 10,000 square feet) or term (*e.g.*, more than five years). The definition of Major Lease should be narrowly defined, so that it will apply to as few leases as possible. In doing this, your client's future leasing plans for the property should be taken into account.

As to any lease that is not a Major Lease (a "Minor Lease"), the lender's consent is frequently required only if such lease does not provide for market rents and terms or is not on the borrower's standard lease form approved by the lender. Since leases are rarely in the exact form of the standard lease, the lender's consent to a Minor Lease should only be required if the terms of the lease materially and adversely deviate from such form. It is preferable (but frequently not possible) to define in the loan documents specifically what deviations are material and adverse (*e.g.*, changes to the subordination provisions, granting of termination rights in favor of tenants not set forth in the form, granting of rights of first offer/refusal or options to purchase in favor of the tenant, changes to specified mortgagee protection provisions (like notice and cure provisions) and other specified provisions of critical importance to a lender).

Loan documents typically contain provisions that the borrower will not approve any assignment or subletting as to certain leases without the approval of the lender. If so: 1) such provisions should generally be limited to Major Leases; and 2) any existing lease that requires the lender's consent that includes a deemed approval provision of the landlord should be adequately dealt with in the loan documents to make sure that the landlord will not have to give its consent prior to the time in which the lender's consent is due. Deemed approval provisions in future leases should be negotiated only if the provisions can be reconciled with the loan documents. Also, make sure that the lender's approval is not required for any renewal, extension, termination, assignment or subletting of any lease pursuant to the express terms of any existing lease or any lease subsequently approved by lender.

If consent is required and if the borrower has sufficient bargaining power, the loan documents should: 1) provide that such consent may not be unreasonably withheld, conditioned or delayed, and; 2) provide for deemed approval of lender after a specified time period.

Finally, the loan documents may contain a provision that limits the borrower's remedy if the lender improperly withholds its consent so that in such case the lender will merely be required to give its consent. However, this can be a real problem for the owner, since it is likely that the owner will have lost the particular tenant by the time that it is determined that the lender's consent was improperly withheld.

Advance Rent

Loan documents typically include a covenant that the borrower will not accept rent more than one month in advance. Any lease that allows a tenant to pay rent on a periodic basis other than monthly — and any security deposits — should be excluded from this covenant. Such covenant should also be revised to provide, on a going forward basis, more flexibility for additional rent (such as operating cost pass throughs and percentage rent). Also, if the property is being used for self-storage, this covenant should be deleted or qualified, as storage tenants are typically required to pay rent more than one month in advance.

Representations and Warranties

It is important to review carefully the representations and warranties relating to the leases and to make sure that there are no exceptions that need to be taken.

Tenant Estoppels

If the borrower is required to deliver tenant estoppels upon request, then such obligation should be limited to borrower using "its commercially reasonable efforts" to obtain and deliver such estoppels in the form required by the lender. Any provision requiring that the estoppels be delivered within a specific time period after request should be made consistent with the time frame required for such delivery under the leases.

Transfer Restrictions

Loan documents typically contain broad transfer restrictions that prohibit the owner from selling, encumbering or transferring the property (or any part) without the lender's consent. These transfer restrictions should not apply to any leasing transaction entered into in accordance with the requirements of the loan documents and the exercise of any existing rights of first offer/refusal or purchase option. If a

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Trouble in Lease Land

A Guide to Retail Lease Workouts

Part Three of a Three-Part Article

By M. Rosie Rees

Parts One and Two of this article discussed a variety of methods to keep the tenant operating. The conclusion herein addresses lender issues and tax considerations.

Lender Issues

Once the landlord has decided to modify a lease for a troubled tenant or a troubled center, it must first check its loan documents. The landlord may find that certain concessions it wants to give are not permitted under the loan documents without the lender's consent. The parties might then tailor the lease modifications either to avoid the need for consent or make consent easier to obtain.

The lender will probably have the right to consent to "material changes," which include any lease modification that: 1) reduces the rent stream; 2) downsizes the tenant's premises; or 3) gives the tenant the right to terminate the lease. The landlord will have to convince the lender that it is in the best interest of the project to retain the tenant with these modifications.

The lender may be willing to agree to changes that do not require giving the landlord additional funds, but may not be willing to increase allowance payments or provide funds for the landlord to perform the tenant's build out.

Tax Considerations

Many of the foregoing techniques can have significant tax consequences to both the landlord and the tenant. Landlords and tenants should consult with their tax advisors early in the workout process. Federal income tax issues that should be analyzed include, but are not limited to the following.

Income vs. Reimbursement

Each party will need to determine whether a particular payment between a landlord and tenant (*e.g.*, construction allowances and termination fees) is income to the recipient that must be recognized in the year of receipt, or whether such payment can be deferred or characterized as a reimbursement.

Deductible vs. Capitalized

Each party will also need to determine whether a particular payment between a landlord and tenant is deductible by the payor or whether such payment is required to be capitalized and depreciated or amortized (and the applicable depreciation or amortization period).

Participating Rents

The parties also need to consider whether certain "participating rents"(for example, percentage rent or relief based on gross sales) will: 1) create "unrelated business taxable income" for direct or indirect tax exempt investors; or 2) generate non-qualifying income for a real estate investment trust.

Section 467

Another concern is whether the prepayment or deferral of rents, or rents that fluctuate from year to year, will cause a lease to be subject to Section 467 of the Internal Revenue Code. Code Section 467 imposes on landlords and tenants a formula for determining the income and deductions that must be accrued in connection with a lease, which income and deductions may not match the actual cash payments contemplated by the terms of the lease.

Local Tax Issues

The income tax rules in most states will generally follow federal principles. One purely local issue will be the possibility of transfer taxes or reassessments of property taxes in connection with an extension, termination or an assignment of the lease.

Litigation Concerns

A primary goal of negotiating a lease workout is to resolve the parties' disputes amicably and avoid litigation. However, much of these negotiations will take place in the context of one or more defaults under the lease by either the landlord or the tenant. It is a good idea for each party to understand the rights and remedies available under law arising from such defaults, to gauge the necessity and benefits of any proposed compromise. Having a litigator review the lease early on, to assess the available remedies and the likelihood of recovery, may be very cost effective.

Conclusion

When financial problems affect the ability of a retail landlord or tenant to perform its lease obligations, both parties can be mutually benefited by working out a solution that keeps the tenant operating and paying rent. By understanding the lease workout methods available and their corresponding consequences, retail landlords and tenants can tailor their agreements to alleviate the financial strain on the tenant and maximize the occupancy of the center.

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Tax-Exempt Issues

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the IRS will recharacterize the arrangement as a joint venture, or partnership (and tax the profits received by all "partners"), if it concludes that the reality is that the two parties are sharing profits, regardless of the terminology of the agreement. A provision permitting the parties to renegotiate the base rent at some point in the future based either on agreement or on a reappraisal of the property, can also be a hidden time bomb. Unless the lease carefully sets appropriate parameters to the process, there is nothing to prevent the parties from basing their new agreement on net income, or the appraiser from using net income of any person as one of the bases of the appraisal.

The next article in this series will discuss the applicable Treasury Regulations and IRS rulings under the federal Tax Code, as well as other issues that arise if the property is developed and sold.

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THE LEASING HOTLINE

Bankruptcy

A debtor's obligation under a lease should be prorated to cover the post-petition, pre-rejection period. *In re Elizabethtown Family Care Clinic, LLC*, Case NO. 08-31544(1)(7), December 18, 2008.

The tenant (debtor), a medical office, and landlord entered into a lease agreement for a term of three years. Thereafter, the tenant defaulted on the lease and filed a voluntary petition under Chapter 7 of the Bankruptcy Code. The landlord filed a motion seeking administrative expenses under 11 USC § 503(b)(1)(A). Although the parties agreed that the landlord was entitled to an administrative claim, the amount of the claim was in dispute. The trustee, on behalf of the debtor, argued that the amount of rent should have been prorated for the month that the debtor filed its bankruptcy claim. The court agreed. It held that a debtor's obligation under a lease should be prorated to cover the post-petition, pre-rejection period, regardless of the date that the rent was billed under the lease.

Restrictive Covenants

A court may not award a judgment on the pleadings for a restrictive covenant where the definitions as contained in the original declaration were not clear. *Dillon Real Estate Co., Inc. v. American National Insurance Co.*, No. CV-08-01508-PHX-FJM, United States District Court for the District of Arizona, Dec. 11, 2008.

Two property owners owned adjoining pieces of land upon which one shopping center was built. The owners signed a declaration with restrictive covenants, including exclusive use provision, and easements that run with the land. One of the property owners leased space to a company called SFDC (d/b/a Fry's Food & Drug Store). Thereafter, the other property owner sold the property and the successor-in-interest leased space to a Dollar Tree store. The other property owner commenced an action, holding that the Dollar Tree was selling grocery items in violation of the exclusive use provision, and sought compensatory damages and injunctive relief. It then moved for a judgment on the pleadings. The court denied the motion, holding that a judgment on the pleadings is only appropriate where the moving party has established that no material issues of fact exist. The court held that because the issue of "grocery items" was not defined in the original declaration, it remained in dispute whether Dollar Tree actually sold "grocery items." Furthermore, the declaration was unclear whether it applied to the successor-in-interest.

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Leasehold Financing

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there is at least a chance the landlord will avoid the hassle and expense of having to find a replacement — which remediation may be required by statute, and which, in any event, is likely to be difficult in today's market. Last, should the tenant be unable to obtain financing and default, the landlord may have to bear the costs of enforcing its remedies against the tenant; whereas, it will almost certainly be easier and less expensive for the landlord to cooperate as much as possible in helping the tenant gain access to the financing it needs to continue its operations — and of course, to pay rent.

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Bridging the Gap

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tenant has the right to purchase only a portion of the property, then you will need to negotiate a partial release provision in the loan documents.

Prepayment

If the loan documents include a prepayment lockout period, then such lockout period should not apply to the exercise by a tenant of any rights of first offer/refusal or other purchase option (if applicable). If a tenant has the right to purchase only a portion of the property, then the borrower will need the right to make partial prepayments.

Insurance Provisions

If the tenant is responsible for maintaining the insurance for the real property and improvements (usually in the case of single tenant properties or in ground leases), make sure that the insurance requirements in the loan documents are consistent with the tenant's insurance obligations under the lease.

Conclusion

This article highlights some (but certainly not all) of the leasing and loan issues that should be taken into account when negotiating leasing documents and loan documents, respectively. It is important to understand and take into account: 1) for lease transactions, the leasing approval requirements under existing loan documents and the interests of lender (existing and future), or; 2) for loan transactions, the obligations of the landlord under the existing leases, the rights of tenants under such leases and your client's future leasing goals for the property.

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