

Leasehold Financing: Key Issues for Mortgage Lenders

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When entering into a long-term ground lease, one of the ground lessee's principal concerns is assuring that its leasehold interest in the property is "financeable."^[1] A mortgage lender providing financing to the holder of a leasehold interest needs to confirm the ground lease contains certain key features in order to protect its lien position during the term of the loan and maximize the likelihood of a successful refinancing.

Fee Mortgages

The prospective leasehold mortgagee should confirm that there is nothing in the ground lease that would cause the ground lessee's interest and the leasehold mortgage to become subordinate or inferior to a subsequent mortgage granted by the ground lessor on its fee simple estate. Before closing on the leasehold financing, a lender should also confirm that no mortgage on the ground lessor's estate already exists.

Assignability/Mortgagability

The ground lessee's interest should be freely assignable such that the ground lessor does not have any approval rights over (i) the granting of the mortgage by the ground lessee, (ii) the realization on the leasehold by the leasehold mortgagee in connection with an action to foreclose the mortgage or (iii) the sale of the leasehold by the mortgage lender (or its designee) to a third party buyer after the foreclosure is complete.

Many ground leases require the ground lessee to provide written notice to the ground lessor of the granting of a mortgage and the contact information of the mortgagee (which is certainly fine, and indeed a good idea), but the leasehold mortgagee should be wary of provisions that require the ground lessor's "consent" to the mortgaging and/or assignment of the leasehold. It is also important to review the ground lease to see if it provides that only a certain "type" of mortgagee may qualify as a "permitted" or "recognized" lender. That is, some ground leases state that only an "institutional lender" or "financial institution" may be a recognized and permitted leasehold lender. These definitions must be reviewed (and sometimes revised) to make sure they are not overly narrow or restrictive. In addition to making sure these definitions do not unnecessarily exclude certain types of financing sources, it is not uncommon to see the "leasehold mortgagee protections" in ground leases being "extended" to mezzanine lenders and preferred equity providers to facilitate financings that involve multi-tiered capital stacks.

Notice of Default and Opportunity to Cure

It is critical that the ground lease contain provisions requiring the ground lessor to provide the leasehold mortgagee with a copy of any notice of default sent to the ground lessee (these notices should be provided simultaneously) and an independent opportunity for the leasehold mortgagee to cure the ground lessee's default. The exact number of "extra" days afforded the mortgagee to effect a cure (i) for a monetary default (five or ten business days beyond what is afforded the ground lessee is not uncommon) and (ii) for a non-monetary default (30 to 60 days beyond what is afforded the ground lessee is also not uncommon, and sometimes, depending on the circumstances, such additional time as may reasonably be necessary to actually obtain control of the leasehold property), is another important issue to be aware of when reviewing the ground lease.

New Lease

The right to obtain a "new lease" from the ground lessor in the event the ground lease is ever terminated, including being rejected in a bankruptcy proceeding, is also a key element of a "financeable" ground lease. The ground lessor will often require the mortgage lender to elect or exercise its right to obtain a new lease within an agreed upon time frame after termination of the lease (30 or 60 days is not unusual) and to cure defaults committed by the prior ground lessee (to the extent such defaults are reasonably curable) before the leasehold mortgagee can earn the right to obtain a new lease and salvage its investment.

Modifications to the Ground Lease

The ground lessor and the ground lessee should not be permitted to amend, modify, or agree to cancel the ground lease without the leasehold mortgagee's prior written consent. Without a lender consent right or override in place, the two parties to the ground lease would be free to negatively impact the lender's collateral through an amendment to the ground lease and/or even cause the collateral to disappear if the ground lease were to be cancelled.

The Term

The term of the ground lease should not be overlooked. A ground lease with a short period of time remaining (five years, for example) or which contains extension options subject to material pre-conditions is problematic and can negatively impact (or completely eviscerate) the refinancability of a lender's position. For an interest-only financing with a substantial balloon payment at maturity, it is, for example, generally recognized that a remaining term of at least 20 years beyond the upcoming maturity date is required in order to maximize refinancability.

Insurance Proceeds/Condemnation Awards

The interplay between the insurance and condemnation provisions of the ground lease, on one hand, and the leasehold mortgage, on the other hand, must be reconciled. From the mortgage lender's perspective, it is important that in the event of a casualty and/or condemnation the proceeds and/or award be used to repair and restore the affected property or be available to pay off the leasehold mortgage. It is important for a mortgage lender to have maximum involvement and control in obtaining and deploying these monies, and it should be made as clear as possible that the provisions of the security instrument (whether mortgage, deed of trust, or deed to secure debt) control over conflicting provisions in the ground lease.

Memorandum of Ground Lease

Although rarely a controversial point, the ground lessor and the ground lessee should be sure to record a memorandum of the ground lease in the land records to register the tenant's interest of record and facilitate the leasehold mortgage financing when it comes time to record the applicable security instrument and secure title insurance.

It is not unusual for ground leases (particularly older ones) to be missing at least some of the key points which make the ground lessee's interest useable for financing purposes. In these situations, the parties often agree to amend or supplement the existing ground lease by adding or refining the missing concept(s) through a ground lessor estoppel and/or amendment to the lease. Such a document can also serve to provide important current information in the "estoppel" segment for the benefit of the prospective mortgage lender, *i.e.*, providing confirmation from the ground lessor that (i) no default exists under the ground lease, (ii) the ground lessor has not encumbered its fee simple interest, and (iii) the lease has not been amended, except as expressly described in the

agreement.

Ground lease financing is complex and care must be taken to review the ground lease to confirm that the mortgage lender has the full list of “protections” for its position during the term of the loan and to maximize the likelihood of a successful take out of its loan at maturity.

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[1] For purposes of this discussion, this Client Alert assumes that the mortgage lender’s lien will not also encumber the ground lessor’s fee simple interest.

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