Lease Financing

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Both lenders and lessees must have a clear understanding of the terms of the lease and any sublease(s), as well as the status of title to the Property, before entering into any financing agreement. When a lender and a lessee enter into a financing agreement, both parties should consider the lease term compared with the term of the loan, any options to purchase the lease, the breach and termination provisions of the lease and the condemnation provisions. Notice of the terms of the lease can be provided to future owners, lenders, and the public through recordation of a memorandum of lease.

One key factor to consider in financing a lease is the term of the loan compared with the term of the lease. When the terms of the lease permit the lessee to encumber the Property with a deed of trust recorded against the leasehold estate, evaluating the terms of the lease to insure it does not expire before the loan is critical. If the lease contains a purchase option, and the lessee does not exercise the option, the lease may terminate at the end of the lease term, and the lender will lose its security interest if the loan is only secured by the leasehold estate. Additionally, if the owner of the fee becomes the owner of the leasehold, typically the fee and the leasehold estate would merge and extinguish the lien secured solely by the leasehold, except when that is not the intent of the parties or when doing so would result in an injustice. The best way to prevent the merger of title from impairing the lender's deed of trust is to either include a no merger clause in the deed of trust or to expand the security to cover the fee interest if the ground lease and the fee estate are held by the same entity.

Frequently, a lease contains termination provisions in additional to the standard non-payment of rent and can include termination of lease when the premises are used for a purpose other than what is expressly listed in the lease agreement. If the lessee is in breach of the lease, the lessor can terminate the lease and take possession of the lease premises. While typically lenders loan to a lessee in reliance on the leasehold security interest, the lease terms can limit the lenders rights to cure certain breaches; such as the use provisions of the lease. Even if the lender can cure certain breached lease provisions, the cist to cure the breach can be significant. Lenders should obtain title insurance to cover their investment (an appropriate ALTA lender's leasehold policy) that insures a lender’s lien interest in the leasehold estate in the real property, which includes the improvements in the land. (See California Civil Code § 765.) Lessees can also obtain a leasehold owner’s policy which will insure its rights under any exclusive use provisions provided by the lessor; in the event such exclusive use provisions are not listed as exclusions from coverage.

Most leases contain a condemnation provision that provides that an eminent domain action will terminate the leasehold estate and all sums from the condemnation proceeding belong to the lessor, other than payments for damage or destruction of improvements paid for by the lessee or any encumbrancer. A sample condemnation provision provides:

> *10. Condemnation.*
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> *(a) If all of the leased premises is taken for a public or quasi-public use by the exercise or by the threat of the exercise of the power of eminent domain, that lease shall terminate as of the date possession is taken by the condemning agency. . .*
>
> *(b) All compensation awarded upon any such taking shall be divided between Lessor and Lessee as follows:*
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> *Lessor shall be entitled to that part of the award or settlement which is attributable to the land taken or to such buildings taken as were on the property an as of the date of the lease term; and Lessee shall receive that part of the award or settlement which is attributable to any buildings taken which were constructed or placed on the premises by Lessee. Lessee shall also be entitled to any moving expenses awarded but shall not be entitled to any compensation for loss of the lease.*
>
> *(c) Lessee may conduct negotiations with the condemning authority, but no settlement shall be made which is not acceptable to Lessor.*
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> *The lessee and lender will want to consider the condemnation provisions as well as any possible subordination provisions related to the acquisition of the Property in assessing the risk of the lease and the security for any loan.*

Each manuscript lease has its own unique provisions including those mentioned above in addition to others such responsibility for tenant improvements, requirements at the end of the lease term to remove the tenant improvements, the cost sharing provisions of the common areas; all which can affect the cost of the lease and additional need for funding. Both the potential lessee and the lender should carefully review the lease provisions prior to signing or providing financing to assess the potential risks.