

Chapter 15

Real Estate Collateral

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§ 15:1 **Introduction**

Real estate law varies sufficiently from state to state to preclude detailed attention here. However, certain considerations must not be overlooked.

§ 15:2 **Future Advances**

Many states, especially those embracing the title theory of mortgages, have conservative views of the nature of those instruments. They regard a mortgage as part of a transaction involving a fixed sum of money paid by the lender to the borrower at the time that the mortgage is executed and repaid by the latter at some future time. Under this theory, a mortgage cannot secure a subsequent advance, or at least it does not confer priority that relates back to the date the mortgage was recorded.

In commercial lending, where the credit extended is as likely to be a line of credit as a term loan, this may present problems that are hardly theoretical. This is also the case in construction lending, where by definition the loan will not be fully advanced at the closing.

Counsel must be aware of the techniques that can be used in the particular jurisdiction. If title insurance companies are dominant in the area, the device selected must satisfy them as the de facto supreme court of land law.

Generally speaking, there are three routes around the problem.

§ 15:2.1 **Equity Mortgages**

An "equity mortgage" may be authorized by local practice. The term properly refers to a mortgage on property already subject to a prior mortgage—a mortgage of the equity of redemption—but the term is used among lenders as a special form of mortgage securing a variable or indeterminate debt.

§ 15:2.2 **Open-End Mortgages**

Some states have special statutes creating "open-end mortgages," which may specifically secure present and future obligations. These laws are often prime examples of nineteenth century technical draftsmanship, and adherence to the statutory form is often mandatory. The

same challenge arises in states where the common law gives relation-back priority to future advances that are “obligatory,” but not to “discretionary” advances.

§ 15:2.3 Alternative Loan Structures

Finally, one can avoid the problem by dividing the transaction into a fixed-term loan secured by real estate and a separate loan, which may be open-ended, against other collateral.

This last alternative is generally a bit awkward (unless it conforms to the actual intent of the lender) and should be avoided unless it is impossible to do otherwise. It also creates problems of cross-collateralization.

§ 15:3 Mortgage on Individual’s Residence

If the real estate collateral happens to be the primary residence of the borrower or a guarantor, consumer protection laws may have some effect, even on a commercial loan transaction (see chapter 17). To minimize some of these effects, the lender might consider structuring the transaction as a loan to an entity, guaranteed by the individual.

§ 15:4 Mortgage As Fixture Filing

Most commercial mortgages contain an elaborate description of included fixtures. It is useful to insure that the mortgage also covers fixtures, and that it complies with the required information and wording of Article 9 for a fixture filing. A mortgage that doubles as a fixture filing does not have to be continued every five years, as would a separate financing statement. This can be useful.

§ 15:5 Third Parties

§ 15:5.1 Collateral Assignment of Leases and Rents

If the real estate collateral has tenants, consider taking an assignment of leases and rents, as illustrated in Form 15.1. In such a case, you should follow Hillman’s Rule and treat the leases and rents as if a court would deem them general intangibles or accounts (and thus personal property), by also filing a financing statement like the one in Form 15.2.

§ 15:5.2 Attornment by Tenants

In most real estate deals, a significant component of the collateral value is the quality of the leases. The loan officer and the credit department assess the economic value of the leases, but it is counsel’s job to preserve that value through appropriate documentation.

Simply getting a copy of the lease is not enough. One needs an *estoppel certificate* from any important tenant. The certificate serves two purposes—it provides a snapshot of the lease transaction, and it gives the lender some protection against any changes in that snapshot. For example: What documents constitute the lease agreement? Is the tenant really the entity we think it is? Is the tenant current on its rent? Has it prepaid any rent? What about common area maintenance (CAM) charges? Has the tenant lived up to its other obligations? Has the borrower/landlord?

An estoppel certificate answers these and other basic but important questions. Form 15.3 is a fairly common example. Some courts hesitate to bind tenants to the terms of estoppel certificates, so this form makes the tenant own up to the fact that the lender will rely on the certificate in making the loan.

The lender should also consider getting the tenant to sign a *subordination, non-disturbance, and attornment agreement* (or, for the acronymically inclined, an “SNDA”). This document simplifies any mortgage foreclosure and sets the rules of engagement between the foreclosure buyer and the tenant after the foreclosure.

To start off, the lease is made subordinate to the mortgage, so it neither impedes nor, as a matter of local real estate law, survives a foreclosure. However, in exchange for this, the tenant gets what amounts to a “virtual lease.” As set forth in Form 15.4, at a foreclosure sale, the buyer takes the property and the right to collect rent, free of most claims the tenant might have against the landlord. The tenant gets to stay in possession, as long as it fulfills its lease obligations. The form also bars the tenant from eroding or destroying the value of the lease through modification, termination or surrender.

Dealing with third parties is not like dealing with the borrower, and tenants are a special case. The tenant may not see that it has any stake in the loan transaction. All the tenant wants is to be left alone to conduct its own business. The tenant certainly does not want to hire a lawyer to interpret some bank document.

Here are some pointers on how to smooth the process. For the tenant who does not see the point, some gentle education can help. For one thing, the arrangement gives the tenant greater assurance that its lease is not hostage to the financial health of the landlord. It also opens up a line of communication to the lender in case it’s needed later on.

The process also tends to be easier if these tenant documents stick as close to plain English as one can manage.

Counsel should also provide drafts of these forms early in the documentation process, to give the borrower time to round up signatures and address the inevitable tenant questions.

§ 15:5.3 Collateral Assignment of a Mortgage

Taking a collateral interest in a mortgage involves some of the same principles as taking an assignment of leases. The lender should perfect as to the promissory note (an instrument) by taking possession, with an endorsement to the lender, and perfect as to the mortgage by recording an appropriate assignment in the real estate records. Case reporters are full of examples of creditors who did one or the other, but not both.

Article 9 of the UCC allows the lender to perfect its interest in the note by filing. However, the prudent lender will take possession, because this confers priority over another secured creditor who perfects only by filing.

§ 15:6 Construction Financing

The construction lender wants to make sure it is getting bricks-and-mortar value for its loans, but a half-finished construction project is rarely worth half the value of a completed, operating project. If the borrower stumbles and falls, the lender might need to put the mess back together and finish the project. From these practical concerns, we derive the particular documentation needs for construction loans.

Let's start with a sample construction loan agreement (Form 15.5).

§ 15:6.1 Conditions on Loan Advances

There are three sets of loan advances under a construction loan—the initial advance (usually to cover acquisition of the site and reimbursement for certain project costs), periodic advances as work progresses, and the funding of retainage to the contractor. All have in common the need for a formal “draw request” with extensive supporting documentation, as in section 2(f) of our sample agreement.

Each type of advance has its own particular pre-conditions. These must be structured to preserve the lender's mortgage priority under local law. Often, as discussed below, this means the advances can be subject only to stated, objective conditions. In other words, the conditions cannot reside only in the lender's head.

For the initial advance, you see the types of conditions we saw in chapter 8, but the borrower must also line up all parts of the construction project:

- Construction contract.
- Plans and specifications.
- Permits and other approvals for the project.
- Proof that the borrower has put up its share of the construction budget.

- Proof that the site has public access and sufficient utilities.
- Builder's risk insurance is in place.

The second tier of conditions is designed to make sure the project is moving in the right direction. The title must be clear, as confirmed by a title examination, an updated endorsement to the title insurance policy, and mechanic's lien releases. If the work has affected boundaries or set-backs, the lender may also require an updated survey.

In our sample, the lien releases from subcontractors and suppliers must come from whoever was supposed to be paid with the previous advance. (In many states, a prospective mechanic's lien waiver is invalid, and the contractor usually finds it easier to round up all the releases when, rather than before, it hands out the checks.)

The project also needs to be on schedule and within budget. For this, the lender may also want the eyes, ears, and advice of its own construction professional. Our sample form combines broad power in the lender's consultant with a clear demarcation of liability for any defects:

(a) Construction Consultant.

- (1) Services. At Borrower's expense, Lender may retain the Construction Consultant for the following purposes:
 - (A) to advise Lender as to the accuracy and sufficiency of the Project Documents for their intended purposes;
 - (B) to assure to Lender that the work and materials provided for in the Construction Contract, the subcontracts, and other contracts related to the Project are required by the Plans and Specifications;
 - (C) to advise Lender as to the accuracy and completeness of Borrower's representations and warranties related to the Project;
 - (D) to make periodic inspections (approximately at the date of each Draw Request) for the purposes of assuring Lender that construction of the Improvements to date is in accordance with the Plans and Specifications, approving Borrower's pending Draw Request as being consistent with the Plans and Specifications, the Project Approvals and the requirements of this Agreement, and advising Lender of the anticipated cost of and time for Completion of Construction and the adequacy of any contingency reserve;

- (E) to review proposed change orders and other proposed changes to any Project Document; and
 - (F) to advise Lender as to any other aspect of the Project on which Lender may seek advice.
- (2) Limitation of Liability. Without limiting any other provision of this Agreement, neither Lender nor the Construction Consultant: (A) makes any representations or warranties of any kind as to the Improvements, including warranties of habitability, warranties of fitness, warranties of fitness for a particular purpose, or warranties as to the absence of defects, and all such warranties are hereby disclaimed, (B) has any other liability to Borrower or to any other Person on account of services performed by the Construction Consultant, any neglect or failure by the Construction Consultant, any approval of, or acquiescence to, the condition of any of the Improvements, or the quality of the construction of the Improvements or the absence of any defects in the Project.
- (3) Cooperation. Borrower shall, and shall cause the Contractor, the Architect, each Engineer, and the subcontractors to give Lender and the Construction Consultant prompt access to the Project Documents and the Project and in all other respects cooperate with Lender and the Construction Consultant.

The conditions for interim advances should also include the types of conditions used for future advances under a line of credit (all initial conditions remain satisfied, and there are no actual or “inchoate” defaults).

The third and final set of conditions ensures the project is completed. In particular, the lender wants verification of these critical points:

- The project is ready for occupancy or sale (as shown by the local government’s issuance of the certificate of occupancy).
- Each key tenant has approved and accepted its space.
- The work really is complete (as certified by the contractor, the architect, the engineer, and the surveyor).
- No one can claim a valid lien for work or materials.
- Permanent insurance is in place.

§ 15:6.2 Representations and Warranties

The lender should be given more assurances than the “standard” reps and warranties found in most loan agreements:

- The project must be feasible. Does the project meet all legal requirements? Is the site buildable? Are the plans and specifications complete? Are all permits in place? Does the site have access to a public street? Does it have adequate utility service? For independent verification, a certificate from the project engineer is helpful (Form 15.8).
- All the details about the relevant construction arrangements must be ascertained. What are the exact and complete terms of the borrower’s agreements with the contractor? With the architect? With the engineer? What about major subcontracts?
- The site must be environmentally “clean.” (Form 15.5 leaves most of the environmental issues to a separate indemnity agreement, discussed in chapter 21.)
- The lender needs a first-priority secured interest in the project. Are the lender’s security documents doing their jobs? Has anyone furnished labor or materials that could create a mechanic’s lien? Are taxes and assessments paid up? Could anything else give rise to a lien?

§ 15:6.3 Covenants

The borrower should be accountable for the work going as planned. The project ought to start on time, move according to schedule, stay within budget, and stick to the plans and specifications. For example:

- (c) Construction. Borrower shall:
- (1) commence construction of the Improvements not later than seven (7) days after the date of this Agreement;
 - (2) diligently construct the Improvements according to the Construction Schedule and the Project Budget;
 - (3) achieve Completion of Construction on or before the Completion Date, all according to the Plans and Specifications, the Requirements, the Project Approvals, and this Agreement;
 - (4) timely comply with all Requirements and Project Approvals;
 - (5) use Advances solely to pay Project Costs according to the Project Budget;
 - (6) pay all Project Costs in excess of the amount of the Loan, regardless of amount;

- (7) promptly correct or cause to be corrected any defects in the Improvements or any departure from the Plans and Specifications, the Requirements, or the Project Approvals;
 - (8) promptly obtain such additional Project Approvals as may become required, necessary or desirable for the construction, operation, and/or maintenance of the Project; and
 - (9) perform such tests as Lender may reasonably request (including soil tests, water tests, concrete and other structural tests, and electrical and mechanical system tests).
- (d) No Deviations. Borrower shall neither:
- (1) modify, rescind, cancel, suspend, terminate, or permit to exist any condition that might result in the modification, rescission, cancellation, suspension, or termination of any Project Document;
 - (2) cause, permit or suffer to exist any deviations from the final Plans and Specifications;
 - (3) approve or consent to any change order or construction change directive that results in the increase of any line item on the Project Budget; nor
 - (4) except as specifically approved in writing by Lender, create or suffer to be created or to exist any easement, right of way, restriction, covenant, condition, license or other right in favor of any Person that may affect title to the Project or the use and occupancy of all or part of the Project.

There is always the risk that a project will run over budget. If the lender sees that happening, the borrower should be the one to come up with the additional funds (sections 2(h) and 2(i)).

The insurance requirements also go beyond what we see in a conventional loan. Builder's risk insurance covers buildings and materials during construction, and we will discuss it in more detail in chapter 20. The lender also wants the shelter provided by the contractor's general liability, workers' compensation, and other insurance, as well as architect's and engineer's professional malpractice insurance. Section 5(k) of our sample loan agreement addresses these points.

In some transactions, the parties contemplate that the borrower will not have sufficient cash flow to service the loan until the project is complete and stabilized. In such cases, the lender may require an interest reserve. The sample loan agreement contains a relatively

simple interest reserve requirement. On my desk is this more elaborate provision:

Interest Reserve.

- (a) At the closing of the Loan, Borrower shall fund and deposit in an account with Lender as an interest reserve (the "Interest Reserve") an amount equal to the deficiency between the projected net operating income from the Project based on executed leases which provide for the commencement of rent following the expiration of a stated period of time (which period of time is reasonably acceptable to Lender) after the delivery of possession of the subject premises (and which are not conditioned on the completion of the remainder of the building in which such subject premises is located), and projected interest payments calculated by Lender based on the maximum amount of the Loan and the interest rate in effect under the Note on the date of the Initial Advance plus two percent (2%).
- (b) Lender may require Borrower to add funds to the Interest Reserve from time to time if any change in the status of the Leases results in an increase in the deficiency as calculated above. Borrower shall make all payments coming due on the Loan. However, Lender reserves the right, without Borrower's request or consent, on any day that interest is due and payable under the Note, to apply the applicable portion of the Interest Reserve to the payment of interest accrued on the Note.
- (c) The Interest Reserve shall remain in effect and funded until such time as the revenue received by Borrower from the Leases in effect is sufficient (as determined by Lender, and sensitized for interest rate fluctuations) to pay all interest accruing and becoming due on the Loan, at which time the Interest Reserve will be released to Borrower.

This cash flow shortfall may also entail adjusting financial covenants, as with the debt service coverage ratio in our sample loan agreement.

§ 15:6.4 Collateral

The collateral security requirements for a construction loan are greater than those found in many basic mortgage forms.

[A] Mortgage and Security Agreement

The mortgage must secure future advances. As discussed earlier, you should make sure the document complies with applicable open-end mortgage laws. The mortgage also needs to secure any advances the lender makes to complete the project after default.

If local law permits, the mortgage should include a security interest in construction materials. In jurisdictions that frown on combining a mortgage and security agreement, use a free-standing security agreement. The documents should also prohibit the borrower from acquiring materials on conditional sales contracts, leases, or retained title agreements. The title insurance company or title counsel should also update the title search to confirm that no one has recorded a lien or lien-related notice since the last time the title was run.

[B] Assignment of Permits and Key Contracts

You should get an omnibus assignment of contracts, licenses, permits, etc., of which Form 15.6 is a sample, and acknowledgments and agreements from the key players (contractor, architect, and engineer). The lender's interest in this additional collateral must be perfected by a financing statement as in Form 15.7.

§ 15:6.5 Remedies

If the project goes into default part way through construction, foreclosure might be the lender's least attractive remedy. The lender needs the option to step into the borrower's shoes and complete the project, then foreclose on a complete package.

The power to do this must be explicit, and is usually found in the construction loan agreement. Most remedies provisions are lengthy and worth a close reading:

- (b) Lender's Rights on Default. On the occurrence of an Event of Default, Lender may at any time, without any demand, presentment, protest or notice (all of which Borrower hereby waives), exercise any one or more of the following rights, all of which Borrower agrees are commercially reasonable:
 - (1) complete all or part of the Project as set forth in § 6(c);
 - (2) immediately terminate its Commitment;
 - (3) declare the principal of and interest accrued on the Note to be forthwith due and payable, whereupon the same becomes forthwith due and payable;
 - (4) obtain the appointment of a receiver for all or part of the Collateral as a matter of right, and if Lender deems that circumstances warrant, the appointment may be on an ex parte basis; and
 - (5) exercise any other right provided for in any Loan Document or under applicable Law.

(c) Completion of the Project.

- (1) If the construction of the Improvements has not been fully completed, Lender may cause the Project to be completed and may enter on the Land and construct, equip, and complete all or part of the Project according to the Plans and Specifications, with such changes as Lender may, from time to time in its sole discretion, deem necessary, appropriate, or desirable. Without limiting the steps Lender may take, Lender may in its sole discretion:
 - (A) use any unadvanced part of the Loan, any of Borrower's funds, and/or other assets;
 - (B) employ existing contractors, subcontractors, consultants, materialmen, agents, architects, engineers, or other Persons, or terminate any of them and employ other Persons on such terms as Lender determines;
 - (C) employ security to protect the Project;
 - (D) use or dispose of Personal Property;
 - (E) execute, deliver, file and record all applications, certificates or other documents on Borrower's behalf as may be required by any Governmental Unit, any Requirement, or any Project Document;
 - (F) pay, settle or compromise all existing and future claims which are or may become Security Interests in the Project or which are necessary, appropriate, or desirable to complete construction of the Improvements;
 - (G) complete the marketing, leasing, and sale of the Project as Lender deems necessary, appropriate or desirable;
 - (H) prosecute and defend all actions and proceedings in any way related to the construction of the Improvements or in any other way affecting the Project; and
 - (I) take such other action, or refrain from taking such action, as Lender may from time to time determine.
- (2) Borrower shall be liable to Lender for all costs paid or incurred for the construction, equipping and completion of the Project, whether the costs are paid or incurred pursuant to the provisions of this Section or otherwise, and whether the aggregate of the costs and

other Advances exceed the amount of the Loan. All costs paid or incurred by Lender constitute Advances, are secured by the Security Documents and payable on demand. If Lender takes possession of the Project and assumes control of construction, Lender has no duty to continue construction longer than it sees fit and may at any time change its course of action or abandon construction and decline to make further payments for the account of Borrower whether or not the Project is completed.

- (d) Manner of Exercising Rights. All rights of Lender are cumulative and may be exercised singularly, alternatively, successively or concurrently at such time or at such times as Lender deems expedient.
- (e) Power of Attorney. Borrower hereby constitutes and appoints Lender and the officers or agents of Lender, with full power of substitution, as its true and lawful attorneys-in-fact with full power and authority in the place and stead of Borrower or in Lender's own name, effective on the occurrence of an Event of Default, to take any and all action and to execute any and all writings that Lender deems necessary or desirable to implement Lender's rights, and, without limiting the generality of the foregoing, hereby gives its attorneys-in-fact attorneys the power and authority, on behalf of Borrower, without notice to or assent by Borrower, generally to exercise any of the rights set forth or referred to in this section as fully and completely as though Lender were the absolute owner of the Collateral for all purposes, and to do at Borrower's expense, at any time or from time to time, all acts and things that Lender deems necessary to protect, preserve or realize on the Collateral, all as fully and effectively as Borrower might do. This power of attorney is coupled with an interest and is irrevocable.

In addition to more conventional remedies, you can see that the lender can finish all or only part of the project, and it can change the project, depending on what it sees as its best exit strategy.

Next come the resources needed to implement this remedy. In many default situations, the borrower is behind in paying its contractor and professionals. To avoid paying twice for the same work, and to assure the cooperation of these parties, the prudent lender will try to get them to agree up-front to keep working under the lender's direction, without looking for back pay. Form 15.9 is a sample contractor's agreement, and Form 15.10 is a sample architect's agreement.

§ 15:6.6 Sale of Individual Units

The borrower's ultimate goal may be to sell off individual lots or completed units. Until the loan is paid off, the parties want an agreed "release price" to be paid on the loan in exchange for the lender's release of the individual piece of the overall project. The lender also wants to make sure that its equity cushion improves with each individual sale and that each sale is legitimate. Here is a sample clause for the release of individual homes:

Subject to the following terms and conditions, Borrower may sell individual dwelling units (each a "Unit") in the Project:

- (a) Lender's obligation to release a Unit from the Mortgage is subject to the satisfaction of the following conditions precedent with respect to such Unit:
 - (1) Borrower has entered into a written agreement for the arm's-length sale of the Unit, on terms satisfactory to Lender, and has given a copy of the agreement to Lender at least twenty (20) days before the earliest proposed closing date on such sale.
 - (2) As of the date on which Borrower closes on the sale of the Unit: (i) all of the conditions set forth in [section stating conditions precedent to the lender's making construction advances] of this Agreement remain satisfied; (ii) all representations and warranties of Borrower in any Loan Document are true with the same force and effect as if made on such date; and (iii) no Event of Default and no event that with notice, lapse of time or otherwise would become an Event of Default, has occurred or is continuing.
 - (3) Borrower has paid to Lender an amount equal to the greater of \$[omitted] or [omitted]% of the aggregate sales price for the Unit in immediately available funds (the "Partial Payment"). The amount paid to Lender shall be applied to the Loan in accordance with the terms of the Note and may not be re-borrowed.
- (b) The foregoing conditions precedent exist solely for Lender's benefit, and Lender in its sole discretion shall determine whether they have been satisfied.
- (c) Lender shall issue a partial release of the unit from the mortgage not later than thirty (30) days after receipt of the satisfaction of the foregoing conditions precedent. Lender's partial release shall be in such form as Lender may determine, so long as it is in recordable form. The partial release shall not affect the Obligations except to the extent of the Partial Payment.

Note that the dollar figure and percentage in clause (3) should be set such that the lender's loan-to-value improves with each home sale and, ideally, that the lender does not have to wait for the last sale before it gets fully paid.

§ 15:6.7 *Planning Ahead*

Traditionally, construction loans required monthly interest payments (sometimes funded by a reserve as discussed above) with principal due in full shortly after the anticipated completion date. This has largely given way to an interest-only loan during construction that converts to an amortizing term loan.

If the "permanent" terms are known at closing, they can be incorporated into the documentation, as in Form 15.5. Even in a traditional loan, the parties may prefer to modify the note and loan agreement after the project is complete, rather than re-document the loan. Therefore, if local real estate law permits, your mortgage should specifically allow for amendments to the obligation. As you will see in chapter 24, this helps protect the priority of your mortgage.

§ 15:7 *Leaseholds As Collateral*

In many instances, a borrower's tenancy may be an asset of major value, either by itself or in connection with the borrower's business.

The difficulties in taking a collateral interest in a real estate lease are multiple, mainly because the asset can evaporate if the tenant defaults on its lease obligations. To preserve the lender's interest in the leasehold estate, there must be an agreement between the landlord and the lender that covers several critical points.

§ 15:7.1 *Authority to Mortgage Lease*

The owner of personal property may transfer its interest in the property outright or as collateral for an additional loan, notwithstanding a "negative pledge" provision in the senior loan documents. The covenant violation might be a default under the terms of the first loan, but the second lender (or purchaser from the borrower) will obtain rights in the collateral.

But assignments of real estate leases follow the rules of local real estate law. Generally speaking, that law provides that a lease prohibiting an assignment or sublease makes it impossible for the tenant to create any rights in the leasehold in any third person.

Therefore, one cannot usually take a collateral interest in a real estate lease without an express authorization by the landlord permitting the leasehold mortgage.

§ 15:7.2 Notice and Right to Cure

Along with getting the landlord's consent, the lender needs the ability to preserve the collateral going forward. Therefore, the landlord must agree to give the lender the same notices of default that are given to the tenant, plus the right to cure—perhaps with more time to cure than the tenant would get under the lease. The extra time may be needed by a lender to become involved in the situation, since it is not “on the spot,” as is the tenant.

In many leases, the tenant waives the right to a notice of default, at least for nonpayment of rent. Even if notice is not waived, there is often no grace period: rent is due on a stated date and not thereafter.

As a result, the landlord must agree that the lender will receive notice of defaults in the payment of rent and a sufficient opportunity to cure the default.

§ 15:7.3 Other Essential Terms

The lender will want the rights to exercise options to extend or renew the lease and to veto any modification of the lease terms which waters down its value. Further, the landlord should agree not to accept a surrender of the premises from the tenant or to block subleases that the lender deems beneficial to its collateral.

To establish periodic baselines for the status of the collateral, the lender will also want to include the requirement of an estoppel certificate from the landlord.

With a ground lease, the subleases are a substantial part of the collateral. The lender should get the landlord's agreement that subleases will survive termination of the lease.

In all cases, the economic value of the lease depends in part on how long it runs for. The term of the lease ought to exceed the term of the loan. If the borrower has an option to extend or renew the lease past the loan term, the lender should require the tenant to exercise the option as part of the loan closing.

§ 15:7.4 New Lease

The borrower's bankruptcy can also impair the value of the lease. A trustee or debtor-in-possession even has the power to reject the lease. This might not happen with a below-market lease. But if the debtor's other problems keep it from reorganizing, the lease may go by the boards. The bankruptcy laws contain strict time limits and requirements for preserving leases. Therefore, if the tenant rejects or otherwise loses the lease, the landlord must agree to give the lender a new lease, on the same terms as the old one.

Form 15.11 at the end of the chapter contains these elements.

§ 15:7.5 Leasehold Mortgage

Having set the stage with the lessor's consent, we can take a leasehold mortgage from the tenant. The requirements for an effective leasehold mortgage vary from state to state. However, building on our discussion of the landlord's agreement, any leasehold mortgage should include the following:

- The mortgagor must strictly comply with lease.
- The mortgagor must give the lender timely notice of any alleged default.
- The lender may cure any default under the lease.
- The mortgagor cannot terminate or surrender the lease.
- The mortgagor cannot modify the lease.
- The lender can exercise extension and renewal options if mortgagor fails to do so.
- Each sublease must meet with the lender's approval.
- The mortgagor must require each subtenant to attorn to any successor in interest to the mortgagor.

