



Beyond the Basics: How to Minimize Risk from Tenants when Mortgaging Leased Commercial Property

Robert A. Hamor

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When a landlord/owner seeks to mortgage or refinance leased commercial property, there are three parties, with three distinct interests, affected by:

- the landlord who is seeking financing;
- the tenant who wants to protect his/her lease; and
- the lender who wants assurance that his/her investment and security interest is sound.

Given these often conflicting interests, landlords must strategically plan and carefully negotiate lease terms that will allow them to mortgage leased property. This means taking the steps necessary to make a transaction appealing to a lender while reducing the risk that a tenant could hold a financing deal hostage. In this second installment of the "Beyond the Basics" series (you can read the first post in the series [here](#)), I will cover the importance of various contractual provisions that could help a commercial landlord position themselves for financing.

Provisions that Help Protect a Landlord's Ability to Seek Financing for a Commercial Property

When negotiating financing with a landlord, a lender wants to ensure that it will have the proper security interest in the property; usually, this is a first-lien position. Accordingly, a significant concern is whether a tenant poses any risks to this security interest.

By including appropriate terms in lease agreements, a landlord can reduce the likelihood that a tenant could disrupt a financing opportunity by holding the process hostage. To help ensure that landlords maintain the flexibility they need to mortgage or refinance a commercial property in Michigan, they should work with experienced legal counsel to determine the appropriate provisions to include in commercial lease agreements, which may include the following:

AUTHORS/ CONTRIBUTORS

Robert A. Hamor

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Subordination Provisions. Michigan is, generally, a “race-notice” state.

This means that the party with an earlier interest in property generally prevails in a priority dispute if the party with the subsequent interest has notice of it. Leases are unique in that a tenant has possession of the property and at least one case has set forth that a party’s possession of property provides constructive notice to others. *Smelsey v Guarantee Fin Corp*, 310 Mich 674, 680, 17 NW2d 863 (1945).

Therefore, landlords may want to include a subordination provision by which a tenant agrees that its interest under the lease will be subordinate and lower to that of the lender in any current, or subsequent financing.

However, landlords should be aware that courts have held that, when a tenant subordinates its interest, the underlying lease may be extinguished in the event of a foreclosure if additional protections (such as an attornment provision discussed next) are not built into the lease. *Sturgis Building, LLC v. Kirsch Industrial Park*, Case No. 327454, Aug. 9, 2016.

Attornment. In the event of a foreclosure, an attornment provision requires a tenant to acknowledge the purchaser at a foreclosure sale, or other triggering event, as the new landlord under the lease and continue its terms.

Estoppel Certificates. An estoppel certificate is a very important provision that a landlord can include in a commercial lease to protect him/her—as well as the lender. An estoppel certificate is a legally binding document pursuant to which a tenant represents or promises certain things to be true, often relating to the relationship between the landlord and tenant, and the terms of the lease.

This can include a certification that the lease is in effect, the tenant knows of no breaches by the landlord, the tenant has/had not exercised certain rights under the lease, and other related matters.

Lenders typically require landlords to obtain estoppel certificates as part of a financing transaction and tenants, absent an obligation to provide one in an agreed-upon format, could potentially hold up financing.

Modifications Required by Mortgagee. While landlords cannot materially alter a lease agreement through such a provision, a lease can require a tenant to execute bank documents or addenda to the lease containing non-material changes such as subordination, non-disturbance and attornment agreements (“SNDA”). By including similar provisions in the lease, tenants have a harder time arguing that these documents are a material change.

Landlords must carefully consider how contractual agreements with tenants may impact their ability to mortgage or refinance a commercial property. With forethought, and with the guidance of experienced legal counsel, landlords can often negotiate such provisions into the lease in an effort to minimize the risk that a tenant could stand in the way of a successful transaction.

If you are a landlord and would like to know more about reducing risk in mortgaging leased commercial property along with other related topics, contact Rob Hamor at 248.785.4737 or at rhamor@fosterswift.com.