

How Much Protection Does A Leasehold Mortgagee Need?

Joshua Stein

In this article, the author presents and explains a set of “middle ground” leasehold mortgagee protections that try to balance the concerns of the landlord and the leasehold mortgagee in a simple and straightforward way.

Every real estate developer, investor, or attorney who negotiates a long-term ground lease (a “Lease”)¹ knows that the Lease must be “financeable.” This means the Lease must contain certain provisions (the “Leasehold Mortgagee Protections”) to protect the interests of a likely future Leasehold Mortgagee.

Those interests boil down to assuring that Leasehold Mortgagee can always: (a) take and readily enforce a Leasehold Mortgage; (b) preserve the Lease and its value, even if the transaction goes into default or surprises occur; or (c) abandon a bad investment.²

To achieve these goals, Tenant and its counsel might say a Lease should contain: (a) every possible Leasehold Mortgagee Protection any real estate lawyer has ever devised; (b) absolute clarity and full detail about every single element of every single one of those Leasehold Mortgagee Protections, leaving nothing to be resolved later and no possible hypothetical sequence or confluence of events unaddressed; and perhaps (c) as many words and pages as possible devoted to protecting Leasehold Mortgagee. Such an approach, if

carefully and intelligently implemented, may minimize the possibility that any particular prospective Leasehold Mortgagee or its counsel ever will find a substantive basis to disapprove a Lease. It can, however, lead to complexity, verbiage, negotiations, and risk of error.³

At the opposite extreme, Tenant and its counsel might say a Lease should contain only the bare minimum Leasehold Mortgagee Protections necessary to satisfy the literal requirements and expectations of the rating agencies. The Lease would simply parrot the express requirements of the rating agencies (just the words in their published ground lease criteria), so that in any securitization the Lease should match up to the published words and pass without objection. This approach keeps everything simple and avoids problems.

“Minimal” Leasehold Mortgage Protections will work, though, only if: (a) Landlord and its counsel don’t try to festoon those “minimal” Leasehold Mortgage Protections with too many conditions, limitations, procedures, qualifications, requirements, restrictions, and so on; and (b) no future prospective “B-piece” buyer, Leasehold Mortgagee, participant, purchaser, rating agency, or syndicate member ever decides it wants the Lease to contain more than the bare minimum Leasehold Mortgagee Protections as the rating agencies had publicly defined them when the parties negotiated their Lease.⁴

The author has previously published Leasehold Mortgage Protections at both the “minimum” and “maximum” extremes suggested above.⁵ In response to reactions from readers, the author has now prepared a “middle ground” set of Leasehold Mortgage Protections, which is presented here, after these introduc-

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tory comments. These “middle ground” Leasehold Mortgagee Protections seek to give Tenant and Leasehold Mortgagee a reasonably succinct, simple, straightforward, “fair,” and almost always adequate way to address each of the usual, typical, and standard concerns of a generic Leasehold Mortgagee.

These Leasehold Mortgagee Protections omit many of the following items that often inflate and complicate any Leasehold Mortgagee Protections:

- *Options.* “Bells and whistles” for unusual or nonstandard structures.
- *Negotiations.* Landlord-oriented concessions or qualifications, beyond the bare minimum necessary to prevent laughter by Landlord’s counsel.
- *Details.* Detailed procedures, time limits, notice requirements, and the like.
- *More Details.* Extreme levels of clarity, specificity, and completeness.

Even without these elements, the “middle ground” Leasehold Mortgagee Protections offered here should cover every financeability issue adequately and make any Lease financeable in the eyes of any reasonable Leasehold Mortgagee.⁶ Of course, if a transaction needs “bells and whistles,” these “middle ground” Leasehold Mortgagee Protections will not provide them. The author’s previously published “maximum” Leasehold Mortgagee Protections can help fill that gap.

By leaving out some details, these “middle ground” Leasehold Mortgagee Protections increase the risk of glitches, uncertainty, and surprises. That may, in turn, increase the risk of litigation if: (a) some unusual left-field circumstance or sequence of events occurs; (b) the Leasehold Mortgagee Protections do not address it perfectly; and (c) the parties cannot resolve it in a reasonable way. In general, though, the details omitted from these Leasehold Mortgagee Protections relate only to very hypothetical and unlikely events. Moreover, in the real world, parties can and do virtually always negotiate a reasonable resolution for most unexpected problems that might arise, assuming each has reasonable leverage, although the process can be painful and expensive.

These Model Leasehold Mortgagee Protections omit a few provisions that sometimes appear in Leasehold Mortgagee Protections. Each such omission reflects a judgment that the particular provision either: (a) represents excessive detail; (b) imposes a burden on Landlord that is both unreasonable and unnecessary; (c) is highly unlikely ever to become relevant, and can be dealt with in some other reasonable way if it ever does become relevant; or (d) otherwise does not need to be covered.

In addition to looking for “pure” Leasehold Mortgagee Protections, which serve Leasehold Mortgagee’s interests without directly serving Tenant’s, any Leasehold Mortgagee evaluating a Lease as possible collateral for a loan will also care about all the other terms

of the Lease—everything that makes the Lease a valuable asset. That analysis forces Leasehold Mortgagee to consider nearly every issue that can arise in a Lease. Nearly every such issue, if handled badly enough, can make a Lease “unfinanceable.”

To try to cover all these issues in a discussion of Leasehold Mortgagee Protections could turn the discussion into a general discussion of ground leases, which is not the goal here. Nevertheless, Tenant and Leasehold Mortgagee share a few very fundamental concerns. The issues on that “short list” are commonly regarded as Leasehold Mortgagee Protections even though they are not unique to Leasehold Mortgagees. The following “medium” Leasehold Mortgagee Protections cover a few of those fundamental “shared issues”⁷ before turning to issues of concern primarily to Leasehold Mortgagees.

The numbered comments at the end of this article (the “endnotes”) describe some judgment calls, beyond mere omissions, that these Leasehold Mortgagee Protections reflect. Anyone can always argue for some other judgment call. That is inevitable once one tries to identify a “middle ground” approach to a document. Similarly, anyone might deem any omitted issue to be worth covering.⁸

Because of their substantive nature, the endnotes are an important part of this article, which should be considered by anyone reading this article.

In addition to defining a “reasonable” set of Leasehold Mortgagee Protections, the following model seeks to demonstrate straightforward, simple, and comprehensible legal writing, consistent with the author’s published pleas for use of Plain English even in sophisticated commercial real estate transactional documents.⁹ The author tries to prove in this document that attorneys can write substantial legal documents in readable English that nonlawyers can readily understand. Legal documents don’t need to be written in some weird and perverted form of quasi-English, marked by long sentences, convoluted verb structures, the passive voice, redundancy, and gratuitous complexity.¹⁰

The author welcomes comments on these Leasehold Mortgagee Protections, both substantive and stylistic.

Definitions

“Bankruptcy Termination Option” means Tenant’s right to treat this Lease as terminated under 11 U.S.C.A. § 365(h)(1)(A)(i) or any comparable provision of law.

“Fee Estate” means Landlord’s fee interest in the Premises,¹¹ including¹² Landlord’s reversionary interest, all subject to this Lease.

“Foreclosure Event” means any: (a) foreclosure sale, trustee’s sale, assignment of this Lease in lieu of foreclosure, sale under 11 U.S.C.A. § 363, or similar transfer affecting this Lease or (b) Leasehold Mortgag-

ee's exercise of any other right or remedy under a Leasehold Mortgage or applicable law as a result of which Tenant is divested of its interest in this Lease.

"Incurable Tenant Default" means any Tenant Default that Leasehold Mortgagee or New Tenant cannot reasonably cure.

"Lease Impairment" means Tenant's: (a) canceling, modifying,¹³ surrendering, or terminating this Lease, including upon a Loss; (b) waiving any term of this Lease; (c) subordinating this Lease to any other estate or interest in the Premises; or (d) exercising a Bankruptcy Termination Option.

"Lease Termination Notice" means a notice stating that this Lease has terminated, and describing in reasonable detail all uncured Tenant Defaults.

"Leased Fee Value" means the fair market value of the Fee Estate, considered as if it were unimproved¹⁴ and subject to this Lease.¹⁵

"Leasehold Mortgage" means a mortgage, deed of trust, collateral assignment, or other lien (as modified from time to time) encumbering this Lease and Tenant's rights under this Lease, including Tenant's leasehold interest and Preemptive Rights.¹⁶

"Leasehold Mortgagee" means a holder of a Leasehold Mortgage and its successors and assigns, provided that: (a) it is not an Affiliate of Tenant; and (y) Landlord has received notice of its name and address and a copy of its Leasehold Mortgage.¹⁷

"Loss" means a casualty or condemnation affecting the Premises.

"Loss Proceeds" means any insurance proceeds or condemnation award paid or payable for a Loss.

"New Lease" means a new lease of the Premises (as amended from time to time in compliance with its terms) and related customary documents such as a memorandum of lease and a deed of improvements. Any New Lease shall: (a) be on the same terms, including Preemptive Rights, and have the same priority, as this Lease; (b) commence immediately after this Lease has terminated; (c) continue for the entire remaining term of this Lease, as it existed before termination, subject to Preemptive Rights; (d) give New Tenant the same rights to improvements that Tenant had under this Lease; and (e) require New Tenant to cure, with reasonable diligence and continuity, and within a reasonable time, all Tenant Defaults (except Incurable Tenant Defaults) not previously cured or waived.

"New Tenant" means Leasehold Mortgagee or its designee or nominee, and any of their successors and assigns.

"Preemptive Right" means any renewal, expansion, or purchase option; right of first refusal or first offer; or other preemptive right this Lease gives Tenant.

"Remaining Premises" means any Premises that Landlord continues to own after a Total Loss.

"Tenant Default" means any default or breach by Tenant under this Lease.

"Tenant Default Notice" means Landlord's notice of a Tenant Default, which notice shall describe such Tenant Default in reasonable detail.

"Termination Option Loss" means any Loss that occurs during the last ____ months of the Term or would cost more than \$____ (beyond available Loss Proceeds) to restore.

"Total Loss" means any: (a) condemnation that affects all or substantially all the Premises; (b) partial condemnation after which Tenant cannot reasonably restore the remaining Premises for use for its previous purpose; or (c) casualty after which, because of changes in law, Tenant cannot legally restore the Premises for use for its previous purpose. Tenant, acting reasonably, shall determine whether a "Total Loss" has occurred under clause "b" or clause "c," but Tenant's determination that such a "Total Loss" has occurred shall not be effective without Leasehold Mortgagee's consent.

Use

Tenant may use the Premises for any lawful purpose.¹⁸

Assignment

Tenant may, without Landlord's consent, at any time assign this Lease provided that Tenant or the assignee gives Landlord a copy of the assignment documents and also, except in the case of an assignment through a Foreclosure Event or a collateral assignment to a Leasehold Mortgagee, Tenant: (a) has achieved Substantial Completion of Development; and (b) causes the assignee to deliver to Landlord an assumption of this Lease.

Subleases

Tenant may, without Landlord's consent, sublease the Premises in whole or in part. If this Lease terminates, Landlord shall not disturb the possession, interest, or quiet enjoyment of any Subtenant not in default beyond applicable cure periods under its Sublease, provided that either: (a) such Sublease demises the entire Premises and is in all material respects at all times no less favorable to Landlord than this Lease; or (b) all the following conditions have been satisfied: (1) Subtenant is unrelated to Tenant; (2) the Sublease was on commercially reasonable and fair market terms when Subtenant became legally bound;¹⁹ and (3) at least one Leasehold Mortgagee has agreed to grant Subtenant nondisturbance protection.²⁰

Loss²¹

If a Loss occurs: (a) the party that first becomes aware of it shall notify the other party; (b) the parties shall direct the payor to pay all Loss Proceeds to Leasehold Mortgagee;²² (c) Loss Proceeds shall be applied as fol-

lows until exhausted; (d) each party's rights to receive Loss Proceeds shall be subject to the rights of such party's mortgagee(s); and (e) the parties shall have the following rights and obligations.²³

Landlord's Costs. First, Landlord shall receive Loss Proceeds sufficient to reimburse Landlord and Fee Mortgagee for their reasonable costs and expenses, including reasonable attorneys' fees and expenses, incurred because of the Loss.²⁴

Total Loss. Second, if a Total Loss occurs, this Lease shall terminate. Landlord shall receive Loss Proceeds equal to the Leased Fee Value as if the Total Loss had not occurred. If, after the Total Loss, any Remaining Premises exist, then: (a) Landlord may require Tenant to remove from the Remaining Premises all debris resulting from the Total Loss, fill in any substantial excavations in the Remaining Premises, and return the Remaining Premises to a level and vacant condition; and (b) Landlord's share of Loss Proceeds shall be reduced by the value of the Remaining Premises. Tenant shall then receive all remaining Loss Proceeds.²⁵

Termination Option Loss. Third, if a Termination Option Loss occurs, Tenant may (subject to the provisions of this Lease on Lease Impairments) terminate this Lease by notice to Landlord.²⁶ Upon such a termination, Landlord shall receive all Loss Proceeds.²⁷

Rent Adjustment. Fourth, in the event of any condemnation of the Premises, except a temporary condemnation or a Total Loss: (a) future Rent under this Lease shall be reduced by the product of such future Rent (as it would have been determined but for the condemnation) times the percentage of the Premises taken, by value; and (b) Landlord shall receive Loss Proceeds equal to the diminution in the Leased Fee Value resulting from such condemnation, taking into account the foregoing reduction in Rent and the effect of the condemnation on the value of Landlord's reversion.

Restoration. Fifth, if this Lease does not terminate because of a Loss, Tenant shall apply Loss Proceeds to remove all debris remaining from the Loss and to restore the Improvements substantially as they existed before the Loss (subject to changes that this Lease would otherwise allow Tenant to make), to the extent reasonably possible under the circumstances.²⁸ Tenant shall then receive any remaining Loss Proceeds.

Disbursement. To the extent that this Lease requires Tenant to apply Loss Proceeds for a specified purpose, Loss Proceeds shall be: (a) disbursed from time to time under reasonable and customary disbursement procedures in Leasehold Mortgagee's loan documents (or, absent such procedures, disbursement procedures as Landlord reasonably determines); and (b) released to Tenant, to the extent remaining, only if and when Tenant has accomplished that purpose.

Fee Mortgages²⁹

Every Fee Mortgage shall be, and shall state that it is,

subject and subordinate to this Lease and any New Lease.³⁰ Any Leasehold Mortgage shall attach solely to Tenant's leasehold estate under this Lease. Any Foreclosure Event under a Leasehold Mortgage shall: (a) transfer only Tenant's interest in this Lease; and (b) not impair any estate or rights under any Fee Mortgage.³¹

Leasehold Mortgages

Without Landlord's consent, from to time, but subject to all other terms of this Lease not inconsistent with this paragraph: (a) provided that any Event of Default has been, or simultaneously is, cured, Tenant may grant Leasehold Mortgage(s);³² (b) Leasehold Mortgagee may initiate and complete any Foreclosure Event; and (c) any transferee through a Foreclosure Event, and its successors and assigns, may assign this Lease.

Lease Impairments

Any Lease Impairment made without Leasehold Mortgagee's consent shall be null, void, and of no force or effect, and not bind Leasehold Mortgagee or New Tenant.³³

Notices

No notice that Landlord gives Tenant shall be effective unless Landlord has given a copy of it to Leasehold Mortgagee. If any Tenant Default occurs for which Landlord intends to exercise any remedies, Landlord shall promptly give Leasehold Mortgagee a Tenant Default Notice.

Opportunity to Cure

Landlord shall accept Leasehold Mortgagee's cure of any Tenant Default³⁴ at any time until ____ days³⁵ after both: (a) Tenant and Leasehold Mortgagee have received the Tenant Default Notice; and (b) Tenant's cure period for the Tenant Default has expired. If Leasehold Mortgagee cannot reasonably cure the Tenant Default within such period, Leasehold Mortgagee shall have such further time as it shall reasonably need so long as it proceeds with reasonable diligence. If Leasehold Mortgagee cannot reasonably cure a Tenant Default without possession of the Premises, or in the event of an Incurable Tenant Default, Leasehold Mortgagee shall be entitled to such additional time as it shall reasonably need to consummate a Foreclosure Event and obtain such possession, provided Leasehold Mortgagee timely exercises its cure rights for all other Tenant Defaults. If Leasehold Mortgagee consummates a Foreclosure Event, Landlord shall waive all Incurable Tenant Defaults.

Cure Rights Implementation

At any time when Leasehold Mortgagee's cure rights

have not expired, Landlord shall do nothing to terminate this Lease or accelerate any rent, or otherwise interfere with Tenant's or Leasehold Mortgagee's possession and quiet enjoyment of the Premises. Leasehold Mortgagee may at its option enter the Premises to seek to cure a Tenant Default. This right or its exercise shall not be deemed to give Leasehold Mortgagee possession of the Premises. Leasehold Mortgagee need not cure any Tenant Default arising from any lien or encumbrance that attaches solely to this Lease (and not to the Fee Estate) but is junior to its Leasehold Mortgage, provided that Leasehold Mortgagee endeavors with reasonable diligence to consummate a Foreclosure Event.

New Lease

If this Lease terminates for any reason (except with Leasehold Mortgagee's consent or because of a Total Loss), even if Leasehold Mortgagee failed to timely exercise its cure rights for a Tenant Default,³⁶ then Landlord shall promptly give Leasehold Mortgagee a Lease Termination Notice. Upon Leasehold Mortgagee's request, Landlord shall enter into a New Lease with New Tenant. Any such request must be made, if at all, at any time before the day that is ____ days after Leasehold Mortgagee has received Landlord's Lease Termination Notice. Landlord's obligation to enter into a New Lease shall be subject to the conditions that New Tenant shall (in accordance with the Lease Termination Notice): (a) cure all remaining uncured Tenant Defaults that New Tenant can then reasonably cure; and (b) pay Landlord's reasonable costs and expenses (including reasonable attorneys' fees and expenses) in terminating this Lease, recovering the Premises, and entering into the New Lease.³⁷ New Tenant need not cure any Incurable Tenant Default.

New Lease Implementation

If Leasehold Mortgagee timely requests a New Lease in conformity with the conditions and requirements of this Lease, then from termination of this Lease until execution and delivery of a New Lease: (a) New Tenant shall be entitled to all net income of the Premises; and (b) Landlord shall not terminate any Subleases except for Subtenant's default, or enter into any lease affecting any of the Premises except with New Tenant. When the parties sign a New Lease, Landlord shall cooperate with New Tenant to transfer to New Tenant all Subleases (including any security deposits Landlord held), service contracts, and operations of the Premises.³⁸ Landlord shall cause every Fee Mortgagee to unconditionally subordinate to any New Lease.

Tenant's Rights Under Lease

If this Lease contains any Preemptive Right and Tenant does not timely exercise it when this Lease allows,

Landlord shall promptly notify Leasehold Mortgagee. Until ____ days after Leasehold Mortgagee has received such notice, Leasehold Mortgagee may exercise the Preemptive Right for Tenant. Leasehold Mortgagee may exercise any or all of Tenant's rights (including Preemptive Rights) under this Lease.³⁹ So long as Leasehold Mortgagee's cure rights under this Lease have not expired, Leasehold Mortgagee may exercise any such rights even if Tenant is in default under this Lease, notwithstanding anything to the contrary in this Lease. Tenant irrevocably assigns to Leasehold Mortgagee,⁴⁰ to the exclusion of Tenant and any other person, any right to exercise any Bankruptcy Termination Option.⁴¹

Certain Proceedings

If Landlord or Tenant initiates any appraisal, arbitration, litigation, or other dispute resolution proceeding affecting this Lease, then the parties shall simultaneously notify Leasehold Mortgagee. Leasehold Mortgagee may participate in such proceedings on Tenant's behalf, or exercise any or all of Tenant's rights in such proceedings. At Leasehold Mortgagee's option, any actions of Leasehold Mortgagee under the preceding sentence shall be to the exclusion of Tenant.⁴² Any settlement shall not be effective without Leasehold Mortgagee's consent.⁴³

No Merger

If this Lease and the Fee Estate are ever commonly held, they shall remain separate and distinct estates (and not merge) without consent by Leasehold Mortgagee and Fee Mortgagee.

No Personal Liability

No Leasehold Mortgagee or New Tenant shall have any liability under this Lease beyond its interest in this Lease, even if it becomes Tenant. Any such liability shall: (a) not extend to any Tenant Defaults that occurred before such Tenant took title to this Lease (or a New Lease), except any identified in a Tenant Default Notice or Lease Termination Notice; and (b) terminate if and when any such Tenant assigns (and the assignee assumes) or abandons this Lease (or a New Lease).

Multiple Leasehold Mortgagees⁴⁴

If at any time multiple Leasehold Mortgagees exist: (a) any consent by or notice to Leasehold Mortgagee refers to all Leasehold Mortgagees; (b) except under clause "a," the most senior Leasehold Mortgagee may exercise all rights of Leasehold Mortgagee(s), to the exclusion of junior Leasehold Mortgagee(s); (c) to the extent that the most senior Leasehold Mortgagee declines to do so, any one other Leasehold Mortgagee may exercise those rights, in order of priority;⁴⁵ and (d) if

Leasehold Mortgagees do not agree on priorities, a written determination of priority issued by a title insurance company licensed in the State shall govern.

Further Assurances

Upon request from Tenant or any Leasehold Mortgagee (prospective or current), Landlord shall promptly and in writing, under documentation reasonably satisfactory to Landlord and the requesting party: (a) certify that this Lease is in full force and effect, whether it is subject to any Lease Impairment, that to Landlord's knowledge no Tenant Default exists, the date through which Rent has been paid, and such other similar matters as may be reasonably requested, all subject to any then exceptions reasonably specified in such certificate; (b) agree directly with Leasehold Mortgagee that it may exercise against Landlord all of Leasehold Mortgagee's rights under this Lease; (c) acknowledge any Subtenant's nondisturbance and recognition rights (provided Subtenant joins in such agreement); and (d) provided that Tenant reimburses Landlord's reasonable attorneys' fees and expenses, enter into any Lease modification that any current or prospective Leasehold Mortgagee requests, if it does not adversely affect Landlord in any material respect or reduce any payment this Lease requires.

Miscellaneous

Notwithstanding anything to the contrary in this Lease, Leasehold Mortgagee: (a) may exercise its rights through an affiliate, assignee, designee, nominee, subsidiary, or other Person, acting in its own name or in Leasehold Mortgagee's name (and anyone so acting shall automatically have the same protections, rights, and limitations of liability as Leasehold Mortgagee); (b) shall never be obligated to cure any Tenant Default; (c) may abandon such cure at any time;⁴⁶ and (d) may withhold its consent or approval for any reason or no reason, except where this Lease states otherwise. Any such consent or approval must be written. To the extent any Mortgagee's rights under this Lease apply after this Lease terminates, they shall survive.

¹ The sample Leasehold Mortgagee Protections below define many capitalized terms. Obvious definitions of other capitalized terms are omitted. "Lease" should include any amendments made in compliance with the Lease.

² Tenant does not directly share the special concerns of a Leasehold Mortgagee—at least if Tenant knows with absolute certainty that it, and its successors and assigns, will never need a Leasehold Mortgagee. A more typical Tenant will, of course, care a great deal about Leasehold Mortgagee Protections. They make a Lease financeable and hence more valuable to a broader universe of future debt and equity investors.

³ It also causes headaches, according to counsel for at least one Landlord.

⁴ The rating agencies' published standards do not always track their current practices.

⁵ See Joshua Stein, "Model Leasehold Mortgagee Protections," *The American College of Real Estate Lawyers Papers*, October 1999; updated and republished for Chicago Title Insurance Company continuing legal education program (2000), Association of the Bar of the City of New York (2000), New York State Bar Association Real Property Law Section (2000); New York State Bar Association Real Property Law Section, *Advanced Real Estate Practice*, 2000; and New York Mortgage Bankers Association (2001). Except the 1999 publication, each of the foregoing included both the "maximum" and the "minimum" Leasehold Mortgagee Protections. Both are periodically updated. Current versions may be obtained from the author.

⁶ This is not a representation or warranty. Any prospective Leasehold Mortgagee's counsel can, if it wishes, almost always find some basis to disapprove any Lease.

⁷ Beyond the "shared issues" covered here, a Leasehold Mortgagee would also look first at the following issues: remaining term, transferability, rent adjustment (including particularly the absolute clarity of any revaluation formula), unusual obligations, alterations, demolition, insurance, and environmental matters.

⁸ Anything these Leasehold Mortgagee Protections omit is generally covered, often at length, in the author's previously published "maximum" Leasehold Mortgagee Protections.

⁹ See Joshua Stein, "Writing Clearly and Effectively: How to Keep the Reader's Attention," *New York State Bar Association Journal*, July/August 1999, at 44; *Secured Lender*, November/December 1999; "Template for a Template: A Checklist To Prepare or Improve Any Model Document," *The Practical Lawyer*, April 2000, at 15; reprinted in *Real World Document Drafting: Form, Style, and Substance* (ALI-ABA professional skills course materials), December 2001, at 131; April 2002, at 151; "How to Use Defined Terms to Make Transactional Documents Work Better," *The Practical Lawyer*, October 1997, at 15, republished in *ALI-ABA's Practice Checklist Manual on Advising Business Clients II: Checklists, Forms, and Advice from The Practical Lawyer*, 2000; and "Cures for the (Sometimes) Needless Complexity of Real Estate Documents," *Real Estate Review*, Fall 1995, at 63.

¹⁰ In "Short and Simple," *The American Lawyer*, October 2002, at 59, the author suggested these seven principles for better legal writing. (1) Break long sentences into shorter ones. (2) Get rid of words, sentences, and paragraphs you do not need. (3) Prefer verbs to nouns. (4) Question any use of a word that includes "here"; try to substitute something less legalistic. (5) Use simple words if you can. (6) Use the active voice. (7) Write larger numbers as numerals. These principles are hardly new, unique, or previously undiscovered. See, e.g., William Strunk, Jr. & E.B. White, *The Elements of Style* (4th ed. 2000). Even so, the legal profession remains largely oblivious to them. The author has tried to apply them consistently in these Leasehold Mortgagee Protections.

¹¹ "Premises" should include appurtenant air rights and development rights.

¹² The Lease should say somewhere, once, that "include" means "without limitation."

¹³ "Modification" seems synonymous with "amend-

ment” or “change,” both of which one also often expects to see, redundantly, in any definition like this one.

¹⁴ This assumes the Lease originally demised raw land. The valuation of Landlord’s leased fee estate raises many issues, including nuances such as how to deal with downzoning or upzoning since the Commencement Date.

¹⁵ For this and other value-related provisions, the Lease should set appraisal procedures.

¹⁶ Mezzanine lenders may want protections like those of Leasehold Mortgagee, but this language does not provide them. Landlord may argue that a mezzanine lender is effectively an equity investor and should rely on its rights as an equity investor rather than bother Landlord. Landlord may want to limit the amount, purpose, or type of loan(s) that Leasehold Mortgages secure. For long-term ground leases, such limitations are generally not market standard or appropriate, at least after Tenant has completed initial construction/development. Once Tenant has reached that point: (a) any Leasehold Mortgage of any size to any Leasehold Mortgagee merely creates a possible future Foreclosure Event and a possible future Lease transfer; (b) Landlord should not care; and (c) even if overleverage creates some theoretical possibility of slightly impairing or temporarily deferring Landlord’s rental income, Landlord’s concerns are not compelling. Tenant will usually agree that Leasehold Mortgagee must: (1) be “institutional”; (2) have a minimum net worth; and (3) meet other objective and reasonable criteria. These concessions will cause definitional issues, complexity, and risk of obsolescence.

¹⁷ Landlord may also want copies of: (a) the unrecorded loan documents; and (b) future amendments. Neither request seems justified.

¹⁸ Leasehold Mortgagee will usually tolerate a somewhat narrower permitted use. Some argue that the breadth of the use clause merely affects the value of the Lease rather than its financeability. That argument may be correct, assuming a narrower use clause remains broad enough so Leasehold Mortgagee can still easily resell the Lease after a Foreclosure Event.

¹⁹ Landlord may also want to assure that, even if the Sublease is at market, Subrent does not decline over time and Subtenant agrees to pay Subrent upon request (and any Sublease termination payments) directly to Landlord.

²⁰ Landlord (and its Fee Mortgagees) may hesitate to “nondisturb” (or more often “recognize”) all future Subtenants, even under the conditions stated. Landlord may argue that once the Lease terminates, Landlord should recover clear possession of the entire Premises, without having to deal with any bits or pieces of Tenant’s failed plan for the Premises. Subtenants that make substantial investments in their space (and Tenant and Leasehold Mortgagee) will feel otherwise, and will usually win this discussion.

²¹ The possibility of a Loss and its variations often consume many pages in a Lease. The parties can negotiate and fine-tune this topic, and create new categories, distinctions, and conditions, to whatever degree they want or can stand. Of all the issues these Leasehold Mortgagee Protections cover, the treatment of a Loss may be the one least suited to a “one size fits all” resolution, but also the one where cost-benefit considerations most cry out for it. These Leasehold Mortgagee Protections make a valiant effort. One lawyer has proposed, not entirely as a joke, that the govern-

ment should: (a) prohibit all condemnation clauses; (b) require any condemning authority to compensate each holder of an interest in the condemned property for the separate value of that interest; (c) collect a minuscule fee from each real estate transaction to establish a condemnation undercompensation protective fund; and (d) use that fund to make whole any real property owner ever undercompensated for a condemnation.

²² Even if Landlord has agreed to allow just anyone to be Leasehold Mortgagee, Landlord can legitimately set standards for who may hold Loss Proceeds.

²³ On the issue of a temporary condemnation, silence will usually suffice.

²⁴ Tenant may want to cap or narrow these expenses, or treat them as a risk of ownership.

²⁵ Leasehold Mortgagees often want Loss Proceeds to go first to repay all Leasehold Mortgages in full. This may be unreasonable, based on the following arguments. A condemnation clause should give each party a package that reflects the value and relative risks/benefits of its position under the Lease if the Lease had continued. Neither party should find itself in a better position (wealthier) after a condemnation than before. Absent condemnation, Landlord would hold a low-risk high-priority relatively fixed annuity (much like a first fee mortgage, *see, e.g.*, “Special Report: CMBS: Moody’s Approach to Rating Loans Secured By Ground Leasehold Interests,” October 23, 2001). In contrast, as holder of a higher-risk and lower-priority interest in the real estate, Tenant (and its mortgagees) would bear the risk of “first loss” if the value and cash flow of the property could not adequately support Landlord, Tenant, and their lenders. To do justice to these positions after a single unexpected “liquidation” of the Premises because of a Loss, Landlord should be paid first, but only to the extent of the value of Landlord’s low-risk annuity under the Lease, including the reversion. Tenant should own what’s left: the risk of inadequate Loss Proceeds, and the possible windfall of excessive Loss Proceeds. In response to these issues, some Leases say Landlord and Tenant share Loss Proceeds in proportion to the relative values of their positions. Landlord may fear that any formula tied to the value of Landlord’s position at the moment of condemnation may undercompensate Landlord if a condemnation occurs during high interest rates or an anomalous real estate market, such as the market that existed in 1991. This undercompensation is much like the loss a mortgagee suffers under 11 U.S.C.A. §§ 506(a) and 1129(a)(7), which let a debtor “cram down” a mortgagee based on current adverse circumstances - temporary impairment of value of the collateral—at the moment of a bankruptcy filing, even though the mortgagee thought it had bought into the real estate for the long haul. The condemnation formula can set a floor for Landlord’s share of the award, taking into account such factors as the remaining term, a maximum discount rate, and a minimum projected residual value. Any such protection will create a corresponding risk for Tenant and Leasehold Mortgagee (a “zero-sum game”). Some of this risk may be insurable.

²⁶ Landlord may want to add a decision deadline. Without one, the courts will infer a “reasonable” time, creating tolerable uncertainty. If a Lease is fully nonrecourse, then: (a) Tenant has a termination option at all times; (b) a further termination option might be a waste of words, so long as Tenant must unambiguously leave behind all Loss Proceeds

if Tenant ever just “walks away”; and (c) a Loss-based termination becomes interesting only when Tenant wants the right to terminate and yet keep some Loss Proceeds, a possibility not provided for here.

²⁷ A “Termination Option Loss” lets Tenant decide whether to terminate. In such a case, Landlord would reasonably argue that Landlord should keep Loss Proceeds, or Tenant should nevertheless restore. Tenant and Leasehold Mortgagee may disagree. Landlord would say that Landlord’s claim to the value of the improvements should defeat the claim of the fickle Tenant and Leasehold Mortgagee, who “chose to walk away.” If, however, Tenant and Leasehold Mortgagee had no real choice, then Landlord’s “expectation”-based claim to Loss Proceeds seems weaker. For example, if a 60-story office building was originally a “legal nonconforming use” but current code allows restoration only as a single-family residence, or if the condemnor took 95% of the site (either, a “Total Loss”), then Landlord still receives its first-priority claim for any resulting diminution in the Leased Fee Value, but any remaining Loss Proceeds (typically the value of the improvements) go to Tenant and Leasehold Mortgagee.

²⁸ Tenant and Leasehold Mortgagee cannot just “take the money and run.” Landlord has its own independent and legitimate interest in seeing the Premises restored. But what happens if Loss Proceeds are insufficient to restore as required? Typically a Lease will require Tenant to make up the shortfall before starting work, but that obligation will not be personally guaranteed. If at that point Tenant chose to “walk away,” then Landlord would receive the remaining Loss Proceeds. The Leasehold Mortgage loan documents will also have something to say about this issue. Landlord will want some ability to control how Tenant restores the Premises. This will raise the same issues as any other major construction project on the Land and usually justify the same outcomes.

²⁹ These Leasehold Mortgagee Protections do not require that any Fee Mortgage must be “subordinate” to every Leasehold Mortgage. That issue is a can of worms caused mostly by confusion about leasehold transactions. Instead, this paragraph tries to explain very succinctly how Fee Mortgages, the Lease, and Leasehold Mortgages interact.

³⁰ Tenant should agree, in the Leasehold Mortgage, not even to try to subordinate the Lease to any Fee Mortgage. Landlord or Fee Mortgagee may suggest that Fee Mortgagee: (a) be superior and prior to the Lease, but (b) enter into an absolute and unconditional nondisturbance agreement with Tenant and Leasehold Mortgagee. Tenant and Leasehold Mortgagee typically reject that proposition in short order, in part because it might be treated as an executory contract in Fee Mortgagee’s bankruptcy. They may, however, reluctantly tolerate a prior Fee Mortgage if Fee Mortgagee “joins in” the Lease when the parties sign it—a joinder in the present creation of a property interest rather than an “executory” promise to do something later. As another option, the Fee Mortgage could be expressly subordinate to the Lease, except during any period when Fee Mortgagee is bound by a fully effective nondisturbance agreement in the form the Lease requires. If the nondisturbance agreement goes away, so does the subordination of the Lease.

³¹ Fee Mortgagee may want the right to cure Landlord defaults. Given the limited scope of Landlord’s obligations under a Lease, Fee Mortgagee’s cure rights can be simpler

than Leasehold Mortgagee’s. But Fee Mortgagee cure rights are neither relevant to financeability of Leases nor uniformly included in Leases.

³² The parties may want to say that Leasehold Mortgagee’s rights end when Tenant has repaid its loan. This seems obvious and hence unnecessary. Silence avoids the need to identify, define, and carve out loan repayments that should not terminate Leasehold Mortgagee’s rights (e.g., those resulting from a Foreclosure Event).

³³ Without Leasehold Mortgagee’s consent, any Lease amendment is not even effective as between Landlord and Tenant. This may be overkill, but it prevents issues, complexity, and controversy that might arise if some amendments were effective between Landlord and Tenant but did not bind Leasehold Mortgagee.

³⁴ If the parties disagree over an alleged Tenant Default, Leasehold Mortgagee may want the right to pay under protest and obtain a refund if Leasehold Mortgagee wins the fight. Such a provision probably duplicates what any court would do anyway under the circumstances. It does not seem essential to financeability, as its absence should not create intolerable risks. Leasehold Mortgagee will want to confirm that Tenant has ample cure periods and dispute rights even before Leasehold Mortgagee’s cure period begins.

³⁵ Landlord may want a shorter cure period for failure to insure. Although this sounds compelling, it is probably not realistic. Landlord should rely on its own (and Leasehold Mortgagee’s) monitoring, a 30-day notice requirement for cancellation, and, if necessary, the ability to expeditiously force-place single-interest coverage at Tenant’s expense.

³⁶ Landlord may argue that this gives Leasehold Mortgagee too many bites at the apple and, for example, Leasehold Mortgagee should lose its New Lease rights if at any time any monetary obligation was more than ____ days past due. Leasehold Mortgagee usually wins this discussion.

³⁷ If a dispute exists about any of these items, Leasehold Mortgagee may want a New Lease even while the dispute is being resolved.

³⁸ From Lease termination until New Lease execution, the Lease could set rules to govern Landlord’s interim leasing program, Subleases, operations, and so on. Given how rarely (if ever) any Landlord has ever terminated a Lease and then entered into a New Lease, the topic probably does not merit the attention it sometimes receives. These Leasehold Mortgagee Protections cover it in a minimal and “broad brush” way.

³⁹ The preceding sentence is not standard, but some secondary market players want it.

⁴⁰ This assignment should also appear in the Leasehold Mortgage and loan documents.

⁴¹ Many Leases address the Bankruptcy Termination Option at length. Everything they say boils down to this sentence and the definition of Lease Impairment. If Landlord rejects the Lease in bankruptcy and Tenant does not exercise the Bankruptcy Termination Option, then Tenant can offset damages against rent. Incorrect offsets can conceivably lead to Lease terminations. Thus, some Leases let Leasehold Mortgagee approve and confirm each offset. These Leasehold Mortgagee Protections contain no such procedures, because: (a) such offsets are quite rare (the author will pay \$1.00 to anyone who can identify one that ever occurred under any mortgaged Lease); and (b) Leasehold Mortgagee can reasonably protect itself through pre-emptive litigation if necessary.

⁴² Tenant will want Leasehold Mortgagee not to exclude Tenant unless an uncured Event of Default exists. Any such restrictions belong in the loan documents, not the Lease.

⁴³ If a proceeding involves a monetary claim of less than \$____, perhaps Tenant should be able to settle it without Leasehold Mortgagee's consent.

⁴⁴ The senior Leasehold Mortgagee may want more control than this paragraph grants. All Leasehold Mortgagees need an intercreditor agreement.

⁴⁵ This clause "c" governs as between Landlord and Leasehold Mortgagees as a group. The most senior Leasehold Mortgagee might want to go further, reserving the right to

determine that a particular Leasehold Mortgagee Protection shall not be exercised at all, by anyone. That issue belongs in the intercreditor agreement among Leasehold Mortgagees, not the Leasehold Mortgagee Protections.

⁴⁶ Landlord may want Leasehold Mortgagee to commit at some point that Leasehold Mortgagee will in fact eventually cure a Tenant Default, especially if construction-related. Leasehold Mortgagee, though, will want a "right to walk" at any time, regardless of how long Landlord may have had to "wait around," and will point out that all monetary obligations will have been kept current at all times.