

Lenders' Risks Regarding Real Estate Leases

Amundsen Davis Banking & Financial Services Alert
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Lenders' risks relating to commercial real estate leases generally seem remote. However, the COVID crisis and associated economic downturn have raised issues that have affected a number of lenders.

What about the scenario where the bank's borrower has a mortgage loan relating to a strip center where the retail tenants have ceased or reduced operations and are making no or only partial payments? The borrower may therefore have little or no cash flow to make its mortgage payments. The bank may be willing to enter into a forbearance or loan modification to give both the borrower landlord and its tenants time to stabilize their operations. This may particularly be the case if the tenants are relatively stable and able and willing to eventually cure the existing delinquencies.

However, this scenario can be made all the more problematic if the bank's customer only has a leasehold interest and the bank has only a leasehold mortgage. In this event, the landowner/lessor, who is not the bank's customer may have leverage to insist that the customer continue making rent payments even though it has no or less income with which to do so. This issue can also be exacerbated if the landowner would like to get rid of the middle-man and enter into a direct relationship with the bank customer's tenants. The bank may be entitled to notice of default and a right to cure, but the economic risk can be allocated to the borrower.

Ultimately, the bank's leasehold mortgage is at risk if the underlying lease is terminated. In this instance the bank may be forced to work with its borrower to cover the shortfall payments of its tenants to maintain the lease. This may require the bank to allow its borrower to cease or reduce payments to the bank or even lend additional funds to protect the mortgage interest. Again, long term your hope will be that the borrower's tenants ultimately cure their delinquencies so the borrower can repay any arrearage it may have on the bank loan.

These issues may not start out as the bank's problems, but they can present significant risks that will force the bank to deal with its borrower's real estate leasing difficulties.

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