Alternative Financing Structures for Real Estate Deals
Leveraging New Opportunities and Minimizing Legal Risks With Sale-Leasebacks, Seller Financing and Ground Leases

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today’s panel features:
Thomas C. Homburger, Partner, K&L Gates, Chicago
Jeffrey A. Usow, Partner, Mayer Brown, Chicago
Jade E. Newburn, Mayer Brown, Chicago

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Alternative Financing Structures for Real Estate Deals

Leveraging New Opportunities and Minimizing Legal Risks With Sale-Leasebacks, Seller Financing and Ground Leases

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Sale and Leaseback Transactions

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Alternative Financing Structures for Real Estate Transactions

Seller Financing

Mayer Brown LLP

October 8, 2009

Jeffrey A. Usow and Jade E. Newburn
Seller Financing

Seller financing may provide a means to bridge the financing gap facing commercial real estate buyers and sellers in the near term.

- **Seller Financing:** A transaction in which the seller of a commercial real estate asset makes a secured loan to the buyer to finance a portion of the purchase price.

- **Two common types:**
  - Traditional mortgage loans secured by a lien on the property
  - Mezzanine loans secured by a pledge of ownership interests in the borrowing entity

- **Contracts for deed,** in which the seller conveys title after receiving the purchase price over time, are generally not utilized in commercial real estate transactions.
Seller Financing (cont’d)

Seller financing allows for flexibility in deal making

- Buyer and seller may negotiate the interest rate, term of the loan and other loan terms, in addition to the purchase price and other deal terms
- Transactions may be able to close more quickly, as the seller should not need to conduct extensive property-level due diligence
- There may be greater potential for “win-win” outcomes
A seller should consider several questions when considering whether to engage in seller financing:

- What are the seller’s reasons for becoming a lender?
- What are potential deal structures?
- Which asset(s) should be sold?
- Can the seller monetize its interest in the loan?
- How should the loan be documented?
- What are the applicable legal considerations?
- What tax issues should be analyzed?
- Is a short sale strategy applicable?
Whether to Become a Lender

Each seller must consider its reasons for becoming a lender

- Why is the asset being sold now?
- To discharge property level debt it cannot refinance?
- To generate portfolio liquidity?
- To develop a portfolio of secured loans?

Each seller must address certain threshold issues

- Is the seller able and prepared to become a lender with respect to each of the following?
- Organizing documents
- Joint venture documents
- Fund agreements
- Upper-tier credit agreements
- Statutory and regulatory obligations
- Lending laws, including licensing
- Servicing capability
Seller Financing Structure – Key considerations

• From an economic perspective, the key variables in determining the appropriate structure of a seller financing transaction are:
  – The amount of the purchase price that the seller must receive in cash at closing
  – The amount of the purchase price that the buyer can pay in cash at closing

• Example #1:
  – Buyer pays:
    • 50% of purchase price in cash
    • 50% of purchase price in first priority seller financing
  – This structure is most likely to be utilized by funds or other entities which own real estate assets that are subject to little, if any, debt
  – If, however, the seller needs cash in excess of 50% of the purchase price (e.g. to discharge its existing debt) or if a buyer cannot contribute 50% of the purchase price in cash without access to other financing sources, then the percentages must either be revised or this structure may not be successful
Seller Financing Structure – Alternative Scenario

The seller may also lend in second position

• Example #2:
  – Buyer pays 20% of purchase price in cash
  – Buyer borrows 50% of purchase price from third party lender in first position
  – Seller lends the remaining 30% in second position

• Advantages:
  – Buyer achieves greater leverage and reduced equity requirement
  – Seller may receive increased interest rate

• Additional considerations:
  – Sellers may set up a program with third party lenders that agree to lend in first position
    • The intercreditor agreement may be negotiated in advance
    • The seller may be able to offer a complete financing solution
Choice of Asset

A seller should consider several variables in selecting the asset which is subject to seller financing

• Both parties want the asset to be strongly-performing
  – Buyer: equity returns
  – Seller/lender: debt repayment

• Economic considerations
  – Is there a prepayment penalty on the existing property level debt?
  – Are the cash proceeds of a sale sufficient to discharge the existing property level debt?
    • If not, the seller must either contribute cash at closing or sell part of the seller financed loan at closing or
    • The existing lender would need to allow a partial repayment or assumption by the new buyer

• Major advantage: a seller has broad latitude to choose its collateral
Monetization

A seller must consider how it will monetize its interest in the seller financed loan

• Two basic options:
  – Hold loan to maturity, which may be acceptable if:
    • The loan has a short term with limited extension rights
    • The seller can wait to be repaid
    • The seller is not able to sell the loan on the secondary market
  – Sell all or part of the loan
    • The seller will wish to structure the loan to maximize its value on the secondary market
Monetization

A seller has at least four potential options to monetize all or a part of its interests in a seller financed loan

• Sell the entire loan
• Syndicate the loan (at least one additional lender originates the loan with the seller and receives its own note from the buyer)
• Form a joint venture with a third party to originate the loan
• Sell participation interests in the loan (the right to receive certain payments received by the seller)
Monetization (cont’d)

• The value of the interests sold by the seller depends upon the type of “sale” and other market conditions
  • Sell entire loan
  • Syndicate loan
  • Form joint venture
  • Sell participation interests
    • Value should be based upon buyer’s credit risk and the condition of the property
    • To the extent the syndicate or joint venture originated the loan, value should be based upon buyer’s credit risk and the condition of the property
    • Buyers of participation interests own a contractual right which is derivative of the seller’s rights. Accordingly, the value of a participation interest also may include the risk of seller default

– Other factors determining value in secondary market
  • Extent to which a loan must have a “seasoned” payment history
  • Changes in economic conditions of the asset and the buyer

– The extent to which seller financed loans may be resold on the secondary market is fact driven
  • Buyers of loans may still be looking for bargains/distressed loans
  • Accordingly, sellers may need to hold their loans in the near term or sell at a discount
Loan Documentation

• In general, a seller should document a seller financed loan on the same terms as a third party lender

• Standard Documentation:
  – Promissory note
  – Mortgage/Deed of Trust
  – Title insurance policy
  – Guaranty (either non-recourse carveout or payment, as applicable)
  – Environmental indemnity
  – Assignment of leases and rents
  – Legal opinions
  – Appropriate financial covenants
  – SPE covenants
  – SNDAs/estoppels
  – Tax and insurance escrows
  – Lockbox, if junior lender
  – Mezzanine Loan
    • Bankruptcy remote provisions
    • Pledge of ownership interests

If the seller does not expect to market its interests, it may be able to accept less than the full set of loan documents

But, in any event, the seller should negotiate to include the following in the loan documents:

  – A due on sale provision which accelerates the debt upon the direct or indirect sale of the property or the change of control of buyer
  – Appropriate guarantees
  – The right to sell its interests in the loan
**Loan Documentation (cont’d)**

The seller and buyer may negotiate certain non-customary provisions because the seller was the prior owner of the property

<table>
<thead>
<tr>
<th></th>
<th>Buyer</th>
<th>Seller</th>
<th>Possible Solution</th>
</tr>
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<tbody>
<tr>
<td><strong>Set-Off Right:</strong></td>
<td>• Buyer may wish to reduce its payments under the note if it suffers damages under the sale agreement rather than being required to sue the seller</td>
<td>• Seller wants “market” terms</td>
<td>• Seller provide a guaranty to buyer?</td>
</tr>
<tr>
<td><strong>Environmental Indemnity:</strong></td>
<td>• Buyer may resist a full environmental indemnity since the seller previously controlled the property</td>
<td>• Seller wants “market” terms</td>
<td>• Seller may need to give buyer greater protections in the purchase agreement</td>
</tr>
</tbody>
</table>
Legal Considerations

Lenders need to comply with various statutory and other legal requirements

- **Lender licensing**
  - At least thirteen states have lender or broker licensing requirements which may be applicable to any particular transaction (AR, AZ, CA, FL, HI, MD, MN, ND, NV, NY, RI, SD and VT)
  - In California, for example, a seller lending with a sufficient nexus to California (e.g., property located in California) must:
    - Apply for and obtain a license
    - Provide a statutory bond
    - Make annual filings

- **Each seller should take precautions to avoid lender liability claims in:**
  - Making or negotiating any loan commitment or loan
  - Servicing loans

Legal Considerations (cont’d)

• Securities Laws
  – To the extent the seller sells participation or other interests in a loan, it will need to either register the security or qualify for an appropriate exemption

• Private investment funds
  – The maturity date of the loan should not extend beyond the stated liquidation date
  – The fund manager should confirm that equity interests may be converted to debt interests
  – To the extent any investors are pension fund investors which operate as real estate operating companies or venture capital operating companies, the fund manager should consider the impact of the seller financing transaction on the ERISA status of the fund
Tax Issues

Both buyers and sellers should be cognizant of a variety of potential tax issues in a seller financing transaction.

The installment sales rules may apply such that the seller’s gains are spread over time.

- Installment sale provisions
  
  - Under the installment sales rules, a seller may be able to recognize the gains associated with a sale of a real estate asset over time, thereby deferring the payment of some or all of its capital gains tax liability.
  
  - However, under certain circumstances, a seller may be required to pay interest on the deferred tax liability, which may mitigate some of the benefits of the deferral.

See Code Sections 453 and 453A.
Tax Issues (cont’d)

Unrelated Business Taxable Income (UBTI)

• As a general matter, tax exempt entities must avoid UBTI or they risk paying income taxes on such income

• UBTI-sensitive sellers must be sensitive to UBTI considerations in a seller financing transaction
  – A U.S. tax-exempt entity that is a lender generally should not recognize UBTI on interest income
  – However, any fee income for services rendered (e.g., origination fees) may be subject to UBTI taxes

See, generally, Internal Revenue Code (the “Code”) Sections 514(a) and (b)
Tax Issues (cont’d)

UBTI-sensitive buyers must also be aware of potential tax issues in a seller financing transaction

• UBTI includes “debt financed income” which includes income to the extent it was derived through “acquisition indebtedness”

• As a general matter, a UBTI-sensitive buyer who borrows from a seller will incur “acquisition indebtedness” and

• The buyer will be subject to income taxes on the income of the property equal to the ratio of:
  – Average balance of acquisition indebtedness, divided by the
  – Average basis of property

See Code Sections 514(a) and (b)
Tax Issues (cont’d)

However, certain buyers may be exempt from UBTI taxes

• Certain “qualified organizations” (e.g., corporate pension funds and educational endowments) but not private foundations may incur “acquisition indebtedness” without incurring UBTI if certain conditions are satisfied
  – The acquisition price is fixed at the closing and is not dependent upon the financial results of the property
  – The amount and timing of payment cannot be dependent on the financial results of the property
  – The seller leases back no more than 25% of the rentable space of the property
  – The financing is made on “commercially reasonable terms”
    • No specific safe harbors or guidance exists
    • This commercial reasonableness requirement is an independent reason why the loan should be documented on market terms

See Code Section 514(c)(9)(G) and Treasury Regulations
Tax Issues (cont’d)

Foreign sellers and REITs also must carefully analyze the tax effects of a seller financing transaction

• Foreign Sellers:
  – If a non-U.S. person is a lender and is engaged in an active U.S. lending trade or business with respect to the loan:
    • Any income from such loan may constitute income effectively connected with a U.S. trade or business
    • The lender may be subject to tax at a maximum rate of 35%
    • The seller may be required to file U.S. tax returns

• REITs:
  – If a REIT is the seller, the REIT must analyze whether the loan is structured as a “qualifying asset” which generates “qualifying income” for purposes of maintaining REIT status under Code Section 856
  – Provided that certain loan to value and other requirements are satisfied, if the loan is fully secured by a mortgage on the underlying real estate, the loan should not run afoul of the REIT rules
Tax Issues (cont’d)

The seller and buyer also must understand whether the original issue discount rules apply to the transaction

• Original Issue Discount (OID)
  – The OID rules may cause the lender to recognize interest income and the debtor to recognize interest expense based on an economic accrual concept
  – If the “redemption price” of the debt exceeds the “issue price” then interest may be imputed to the seller
    • For example, if interest payments are not at least equal to the applicable federal rate of interest when the debt is issued, OID income may be imputed to the seller
    • In addition, cash payments such as points may cause OID tax liability

See Code Sections 1273(a)(2), 1273(b) and 1274(a). Treasury Regulations 01.1273-3(g)(2)(ii)
Tax Issues (cont’d)

Other tax provisions, such as unincorporated business taxes (UBT), may apply

- **New York City**
  - Income earned by unincorporated businesses (e.g. partnerships and limited liability companies) is subject to taxation
  - If a seller makes more than one loan per year, there could be a risk that the seller or its affiliates might be considered in the business of making loans and thus subject to tax

- **District of Columbia**
  - The District of Columbia imposes UBT taxes on the income earned by non-corporate entities
  - Whether or not an entity is engaged in the “business” of lending is subject to a facts and circumstances test which includes the number of transactions

Short Sales and Defaulted Loans

• Recently, some borrowers have had difficulty in performing under their real estate loans

• Generally, lenders which hold defaulted loans have several options:
  – Lenders may desire to exercise their remedies and take title to the underlying real estate (whether by foreclosure or accepting a deed in lieu of foreclosure)
    • As title-holder, the lender could sell the property to a new buyer
    • In conjunction with such sale, the lender (as owner of the property) may offer “seller financing” to a new buyer
  – Alternatively, a lender may encourage the borrower to sell the asset to a new buyer on terms acceptable to the lender (a “short sale”) in exchange for other consideration (e.g. a release of borrower’s guaranty liability). The lender may also decide to offer “seller financing” to a new buyer
Short Sales and Defaulted Loans (cont’d)

If a Real Estate Mortgage Investment Conduit holds a defaulted loan, special considerations apply

• A Real Estate Mortgage Investment Conduit (REMIC) is a special purpose entity which holds a pool of commercial and/or residential mortgages in trust and issues securities backed by those assets to third party investors

• Under the tax rules, if a REMIC trust takes title to a real estate asset,
  – It must sell the asset within 3 years and
  – It generally cannot offer “seller financing” because it cannot acquire a new mortgage loan after its “start up date” (the date on which the trust issues its interests)

• These constraints may affect the REMIC trust’s strategy for dealing with a defaulted loan

See Code Sections 860G(a)(8)&(9), 856(e)(2) and 860D(a)(4)
Short Sales and Defaulted Loans (cont’d)

• One potential solution is a short sale conducted under the supervision of the REMIC trust
• Instead of foreclosing, the REMIC trust and the borrower arrange for the borrower to market the property through a short sale process acceptable to the REMIC trust
  – The REMIC trust approves the selling broker and the terms of the sale
  – As a part of the terms of sale, the REMIC trust would offer “seller financing” to the buyer by allowing the property to be sold subject to the existing loan, which is then restructured
Short Sales and Defaulted Loans (cont’d)

By utilizing short sales, REMIC trust lenders may be able to:

• Avoid the three year holding period limitation and
• Facilitate the sale of the property to a new buyer, which buyer assumes the modified REMIC loan

• Note: It is easiest to modify a loan (e.g. term and interest rate) held by a REMIC trust when the loan is either in default or imminent default without adverse REMIC tax issues

• Lenders pursuing a short sale strategy should consider what they are willing to provide borrowers to obtain their cooperation (i.e. release of guaranty obligations)

See Treasury Regulations 1.860G(b)(3)(ii), 1.860G(b)(5), 1.860G-2(b)(3)(i); Code Sections 860F(a)(2) and 860G(a)(3)
Conclusion

- Seller financing may offer significant benefits given present conditions in the credit markets.
- Sellers should carefully consider the practical, strategic, economic, legal and tax issues with legal counsel if they are considering entering into seller financing transactions.
- Short sales may provide a means for lenders to clear their inventory of defaulted or distressed loans, particularly in the case of REMIC securitization trusts.
Presenter Biographies

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Jeffrey Usow is a Firm Practice Leader in the Real Estate group. He represents lenders, developers and real estate investment trusts in financings, purchases and sales, and leasings and other transactions. He has significant experience with the real estate investment group of a Chicago-based insurance company, including loans for a variety of property types, equity participations, credit enhancement, workouts, deeds-in-lieu of foreclosure, securitizations and REITs.

Jeffrey "combines an approachable nature with a consistently high-quality work product" (Chambers USA 2007). He was listed in The Best Lawyers in America, 2008.

Jeffrey received his JD from Harvard Law School, *cum laude*, in 1977. Prior to law school he attended the University of Wisconsin where he received his BA in 1974.
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Jade Newburn represents real estate investment trusts, insurance companies, pension funds, opportunity funds, developers, investors and lenders in a wide variety of office, retail, medical office building and industrial real estate transactions. He has substantial experience representing both equity investors and developers in the creation of joint ventures for the purpose of acquiring, developing and managing real estate assets. He regularly represents clients in the acquisition, financing and development of individual properties and multi-asset portfolios. He also represents financing institutions in construction and permanent financing transactions and commercial landlords and tenants in leasing transactions.

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5

Sale and Leaseback Transactions

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I. [5.1] SCOPE OF CHAPTER

This chapter is an analysis of the law and practical considerations involved in sale and leaseback financing transactions, including certain relevant tax aspects. When appropriate, sample provisions of purchase and sale agreements, leases, and deeds peculiar to sale and leaseback financing transactions are presented.

II. INTRODUCTION

A. [5.2] In General

When appropriate in this chapter, reference has been made to applicable law and publications on sale and leaseback financing. Since there is so little Illinois law on this subject, citations and references are not restricted solely to Illinois cases but include cases from other jurisdictions and publications and works that consider problems involved in sale and leaseback financing on a nationwide basis. See §5.88 below for additional sources.

A sale and leaseback transaction is what its name implies. In its simplest form, the owner of the property sells it to an investor, who then leases the property back to the seller for a term of years pursuant to a net, long-term lease. The seller realizes cash for the property while retaining the use of the property during the lease term. The purchaser acquires the reversionary rights in a valuable asset in the form of the land and the improvements situated thereon and a means of producing a return on the investment in the form of rent payable under the lease during the lease term.

There are basically two types of sale and leaseback transactions, with countless variations from each type:

1. The first basic type involves either the sale of land and/or improvements that are then leased back to the seller, or the sale and leasing back of unimproved land together with the agreement of the buyer-landlord to construct certain improvements on the land for use by the seller-tenant. In this type of transaction, the buyer-landlord owns both the improvements and the land if it has been sold — the seller-tenant’s interest in the improvements (and the land if it has been sold) being solely as a tenant. This type is especially prevalent in transactions in which the buyer-landlord is interested in maximizing tax benefits.

2. The second basic type of sale and leaseback transaction involves the sale and leasing back of land only. Ownership of existing or yet-to-be-constructed improvements is retained by the land seller-tenant during the term of the lease. See, e.g., PCH Associates v. Liona Corp. (In re PCH Associates), 55 B.R. 273 (Bankr. S.D.N.Y. 1985); In re Kassuba, 562 F.2d 511 (7th Cir. 1977). The buyer-landlord acquires ownership of the land and a reversionary or future interest in the improvements, either existing or yet to be constructed. At the end of the lease term, title to the improvements often passes to and vests in the buyer-landlord. This type is especially prevalent in transactions in which the seller-tenant wishes to retain maximum tax benefits.
At times, the sale and leaseback format is also accompanied with an option by the seller-tenant to repurchase the subject property at some future time.

This chapter considers two basic types of sale and leaseback transactions: (1) the buyer-landlord buys and leases back all of the interest of the seller-tenant in the land and existing improvements; and (2) the buyer-landlord buys and leases back only the land, with the seller-tenant retaining ownership of existing or future improvements. The different ramifications of these two basic types of sale and leaseback transactions are discussed throughout this chapter. See S. Douglas Weil, *Land Leasebacks Move Up Fast as Financing Technique*, 1 Real Est.Rev., No. 4, p. 65 (Winter 1972), for useful examples of the business effect of sale and leaseback financing transactions.

B. [5.3] Background

The sale and leaseback technique in its simplest form has been in use in England since the late Nineteenth Century. An 1882 English case, *Yorkshire Railway Wagon Co. v. Maclure*, 21 Ch.D. 309 (1882), involved such a transaction. Sale and leaseback transactions first became popular in the United States during the 1940s. The early sale and leasebacks were simple transactions generally involving institutions with special tax advantages, e.g., educational institutions, pension funds, or other tax-free institutions, as the buyer. The seller-tenants were generally large corporations with substantial amounts of their assets tied up in real estate. Since the 1950s, developers and financiers have expanded the basic sale and leaseback concept to dizzying heights of complication. These developments were in large part pioneered by William Zeckendorff, who developed the “pineapple” theory of sale and leaseback financing. The basis of this theory is that if a piece of real estate could be broken into separate estates (e.g., fee interest in the land and reversionary interest in the building, fee interest in the building, sublease of the building, management agreement to operate the building, subleases of parts of the building, etc.), each held by different entities, the total value of all of the parts would be worth more than the value of the undivided property before the carving-up process began. In the last several years, the complicated financing techniques developed during the past decades have been embraced and expanded by syndicators and financial institutions as a means of maximizing economic returns and tax benefits from the subject properties. William L. Cary, *Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations*, 62 Harv.L.Rev. 1 (1948); *SALE AND LEASEBACK FINANCING*, xvi – xvii (PLI, 1973); S. Douglas Weil, *Land Leasebacks Move Up Fast as Financing Technique*, 1 Real Est.Rev., No. 4, p. 65 (Winter 1972).

Over the years, sale and leaseback financing transactions have proved to be good investments for buyer-landlords such as charitable and educational institutions, pension funds, institutional investors, and real estate investment trusts looking for a “bond-like” passive investment as well as for individual investors and syndicated partnerships primarily seeking tax shelters. Recently, sales and leasebacks, in their more complicated guises, have also been used by buyer-landlord investors as a means to participate in a portion of the cash flow of the leasehold estate and of the proceeds of financing the leasehold estate. Similarly, the sale and leaseback transaction has proved an effective vehicle for seller-tenant entities attempting to raise funds in excess of first mortgage proceeds (thereby avoiding the necessity of often more expensive second mortgage
financing or of refinancing an advantageous first mortgage), for entities attempting to obtain funds in tight mortgage markets and in mortgage markets dominated by high interest rates, and for entities seeking the tax advantages more fully described in §5.4 below.

C. [5.4] Advantages of Sale and Leaseback to Seller-Tenant

There are many situations in which sale and leaseback financing transactions afford particular advantages to a seller-tenant. The advantages will vary, of course, according to the particular circumstances of the seller-tenant.

In general, the seller-tenant will realize a greater amount of cash from the sale of the property than would be obtained by means of a single loan with property given as security. A buyer-landlord investor will pay full or close to full value when purchasing property, especially if the seller-tenant has a good credit rating, whereas in a loan transaction, the same investor might, because of legal or policy limitations, lend up to only 60 to 70 percent of the value of the property. See, for example, the various restrictions contained in §126.15 of the Illinois Insurance Code, 215 ILCS 5/126.15, which limits the loan-to-value ratio of an Illinois insurance company’s investment in various types of loans secured by mortgages on real estate. After a sale and leaseback, the seller-tenant has an asset with greater liquidity, having converted a fixed asset — real property — into cash that can be used for various purposes related or unrelated to the land sold.

In a tight mortgage market, investors who may be unwilling to lend money might enter into a sale and leaseback transaction if it can be structured to offer a hedge against inflation. For example, the lease could require that the rental payments be adjusted in accordance with changes in a specified price index. Similarly, when interest rates on borrowed funds are high, the fixed rent payable in a sale and leaseback transaction over a long lease term, which either is a substitute for mortgage financing or is entered into in connection with the refinancing of a mortgage, may well necessitate lesser outlays of funds on a monthly basis than would be required for equivalent mortgage financing. Such a lower fixed rent can be accomplished, perhaps, by allowing the buyer-landlord to realize part of its return through additional rent measured by a portion of net cash flow or proceeds of financing of the leasehold estate.

Distinct tax advantages can be gained by the seller-tenant in a sale and leaseback of vacant land or in a sale and leaseback of land only, with the seller-tenant in either case retaining title to existing or future improvements. Although taxation issues are beyond the scope of this handbook, the following general principles apply:

1. A sale and leaseback of land only will convert land, a non-depreciable asset for tax purposes, into a leasehold, allowing the seller-tenant to deduct rent payments over the life of the lease. In addition, if the transaction is properly structured so that (a) the seller-tenant’s title to the retained improvements is upheld or the seller-tenant constructs the improvements subsequent to the sale, and (b) the initial term of the lease is not less than the recovery period of the improvements (or useful life, if applicable), the seller-tenant can depreciate the improvements on an accelerated basis (assuming all of the other requirements for accelerated depreciation are met).
2. If improved property has been fully depreciated or if, because of the use of accelerated depreciation, the amount of depreciation deductions will decline, a seller-tenant can sometimes gain a tax advantage by the sale and leasing back of the land and improvements. The rental over the term of the lease will result in expense deductions against the seller-tenant's ordinary income. The deduction for rent will offer a tax shelter in lieu of any lost depreciation deduction that provided a tax shelter prior to the sale.

Raising money by means of a sale and leaseback, instead of incurring debt liability by means of a note or mortgage, can help improve a seller-tenant's balance sheet. Raising money by means of a mortgage loan will result in the creation of a corresponding liability; a sale and leaseback may transform a fixed asset — the real estate — into cash without creating a liability. Avoiding new liabilities permits the seller-tenant to present a more favorable financial statement and may improve its credit rating.

To avoid constituting a liability, however, the lease must be an "operating" lease as defined by the rules of the Financial Accounting Standards Board (FASB). The FASB rules class leases as either "capital" leases or "operating" leases. A lease that transfers substantially all of the risks and benefits of ownership to the lessee constitutes a capital lease that must be reported as a debt obligation by the lessee. FASB Statement of Financial Accounting Standards No. 13, *Accounting for Leases* §7 (Nov. 1976), as amended and interpreted, available at www.fasb.org/st. All other leases are operating leases, which are accounted for as the rental of property. In addition, the seller-tenant must be careful to measure the respective costs of borrowing and leasing. Some commentators argue that the perceived advantage of improving a seller-tenant's balance sheet is an illusion that can result in disaster. See Frank C. Bernard and Sidney M. Perlstadt, *Sale and Leaseback Transactions*, 1955 U.III.L.F. 635, 636, and the authorities cited therein. In addition, there is increasing pressure in the accounting community to change the accounting treatment of long-term leases in general. In the not-too-distant future, all long-term leases may have to be reflected as liabilities on the seller-tenant's balance sheet. See generally FASB Statement of Financial Accounting Standards No. 98, *Accounting for Leases: Sale-Leaseback Transactions* (May 1988) for current accounting views, including treatment of sales and leasebacks.

There are times when an owner is restricted from borrowing money by limitations imposed by indentures or loan agreements or by state or federal regulations. A sale and leaseback as a means of raising additional funds can be useful in these situations unless the indenture, loan agreement, or regulations contain specific covenants to prevent sale and leaseback financing.

D. [5.5] Advantages of Sale and Leaseback to Buyer-Landlord

The most obvious advantage to the buyer-landlord is that of a good return on the investment. The rent under the lease usually is predicated on the complete amortization of the purchase price over the primary term of the lease, often at a higher interest rate than that available on loaned mortgage funds. Even if the fixed rent is at a lower rate than interest rates on loaned funds, additional rent, in the form of a participation in net cash flow and proceeds of financing of the leasehold estate, can increase the buyer-landlord's yield if the project is successful to a return greater than would be realized from a corresponding loan. If the seller-tenant exercises one or more options to extend the term of the lease even at a substantially lower fixed rate of rental, the
buyer-landlord, who has had its investment completely amortized perhaps at a higher rate of interest than in case of a mortgage loan, will derive additional return during the option periods. This results in a higher rate of return, which helps make a sale and leaseback investment attractive to a buyer-landlord. Frank C. Bernard and Sidney M. Perlstadt, Sale and Leaseback Transactions, 1955 U.III.L.F. 635, 646.

Unlike a mortgage loan and absent an option in the seller-tenant to repurchase the property, the buyer-landlord has both a noncallable investment and a reversion in the property after expiration of the lease. At the end of the lease term, the buyer-landlord will have the “total” ownership interest of the land and buildings even after being “repaid” for the property by having its investment amortized through rental payments during the term of the lease. See §5.7 below with regard to the problems raised by the return of land improved with worn-out structures. This may provide a hedge against inflation. In the event of the seller-tenant’s default during the lease term, and assuming the problems of the equitable mortgage discussed in §§5.11, 5.56, and 5.57 below are overcome, the buyer-landlord can terminate the lease and obtain clear title and possession generally faster than a mortgagee who would have to go through the process of foreclosure to realize on the mortgage security. In addition, if equitable mortgage problems are again overcome, the buyer-landlord is not faced with the rights of redemption of the creditors of the seller-tenant, as would be the case in a mortgage foreclosure, and with the right of redemption of an individual seller-tenant, which, in the case of a mortgage transaction, could not be waived. Finally, if the default provision of the lease is properly structured (see §5.68 below), the buyer-landlord will be able to sue the seller-tenant for the present value of the lost future rentals, much the same as the mortgagee would have rights to a deficiency judgment.

A lease that calls for participation in the “upside” of the project through payment of part of net cash flow or proceeds of financing of the leasehold estate as additional rent may withstand the problems of a seller-tenant’s bankruptcy better than a corresponding mortgage loan with equivalent “kicker” interest if the mortgagor is subject to bankruptcy proceedings. In a lease situation, the trustee can either assume the lease, in which case the additional rent provisions will survive, or reject the lease, in which case the buyer-landlord will succeed to title to the property free of the lease. 11 U.S.C. §365. In a loan situation, the mortgagee may well have to content itself with a return of the principal plus perhaps accrued interest while forgoing future kicker interest — the inducement for making the loan in the first place. 11 U.S.C. §501, et seq. See §5.6 below for a discussion of the problems a landlord will probably face on any attempt to collect future rent if a bankrupt tenant rejects the lease.

In some instances, a buyer-landlord can gain a cash-flow advantage by mortgaging the fee interest in the property, subject to the lease, and pledging the lease rentals to secure the payment of the loan while retaining the excess rentals over the debt service. Even if the rentals are used entirely to pay debt service, the mortgage proceeds are available to the buyer-landlord, as are the proceeds of future financing once the current mortgage is fully paid. In such a case, it is of paramount importance that the obligations of the seller-tenant with respect to the leased premises extend beyond the obligations of the buyer-landlord under the mortgage. See §§5.46, 5.47 below. In addition, if the buyer-landlord is a taxpaying entity, the investment will also operate as a tax shelter, permitting the buyer-landlord to take depreciation on the improvements as an offset.
against taxable income. In those cases in which the seller-tenant retains title to the improvements during the term of the lease, this depreciation, of course, belongs to the seller-tenant and is accordingly unavailable for the buyer-landlord's use.

Because of the net lease features of sale and leaseback financing, the investment is quite suitable for an institutional investor that lacks the capacity to manage real estate investments actively.

E. [5.6] Disadvantages to Seller-Tenant

Unlike a borrower in a mortgage loan transaction, the seller-tenant is exchanging a permanent property right for a leasehold interest for a stated term, after which the seller-tenant will have no further interest in the property. The seller-tenant has no ability to reacquire the fee unless it has a repurchase option, which, as discussed later, can cause problems for the buyer-landlord and the seller-tenant if the repurchase option is less than for fair market value. Reversion of the fee at the end of the lease term may result in a loss to the seller-tenant if the fee has appreciated substantially in value during the lease term, especially if the seller-tenant has improved the land extensively. (Even if the seller-tenant can repurchase the fee at fair market value, it must make the equivalent of a loan repayment, plus pay the buyer-landlord the appreciated value.) See discussion on repurchase options at §§5.11, 5.56, and 5.57 below.

The seller-tenant runs the risk that there may have been a miscalculation of the anticipated tax advantages because of either overoptimism, overoperating results, unfavorable treatment by the IRS or the courts, or a change in the tax laws.

The seller-tenant may experience difficulty in obtaining financing for enlarging or remodeling of the improvements. The only financing readily available is through a leasehold mortgage, which is frequently difficult to obtain on reasonable terms. An owner of the fee who has borrowed money under a mortgage loan can refinance the loan, either with the holder of the mortgage or with a third party. It is much more difficult to persuade a buyer-landlord under a lease to make additional improvements for the tenant’s benefit, to furnish funds for the improvements, or to subordinate its fee interest to the seller-tenant’s leasehold lender even though the seller-tenant offers the buyer-landlord a good return in the form of increased rent.

In proceedings involving the landlord under the Bankruptcy Code, 11 U.S.C. §101, et seq., the landlord may be deprived of some of its rights against the tenant arising under the lease. While a landlord-debtor or a trustee of a bankrupt landlord may reject an unexpired lease of real property as being an executory contract, §365(h) of the Bankruptcy Code limits such rights as follows:

(h)(i)(A) If the trustee rejects an unexpired lease of real property under which the debtor is the lessor and —

(i) if the rejection by the trustee amounts to such a breach as would entitle the lessee to treat such lease as terminated by virtue of its terms, applicable nonbankruptcy law, or any agreement made by the lessee, then the lessee under such lease may treat such lease as terminated by the rejection; or
(ii) if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law.

(B) If the lessee retains its rights under Subparagraph (A)(ii), the lessee may offset against the rent reserved under such lease for the balance of the term after the date of the rejection of such lease and for the term of any renewal or extension of such lease, the value of any damage caused by the nonperformance after the date of such rejection, of any obligation of the debtor under such lease, but the lessee shall not have any other right against the estate or the debtor on account of any damage occurring after such date caused by such nonperformance.

(C) The rejection of a lease of real property in a shopping center with respect to which the lessee elects to retain its rights under Subparagraph (A)(ii) does not affect the enforceability under applicable nonbankruptcy law of any provision in the lease pertaining to radius, location, use, exclusivity, or tenant mix or balance.

(D) In this paragraph, "lessee" includes any successor, assign, or mortgagee permitted under the terms of such lease.

(2)(A) If the trustee rejects a timeshare interest under a timeshare plan under which the debtor is the timeshare interest seller and —

(i) if the rejection amounts to such a breach as would entitle the timeshare interest purchaser to treat the timeshare plan as terminated under its terms, applicable nonbankruptcy law, or any agreement made by timeshare interest purchaser, the timeshare interest purchaser under the timeshare plan may treat the timeshare plan as terminated by such rejection; or

(ii) if the term of such timeshare interest has commenced, then the timeshare interest purchaser may retain its rights in such timeshare interest for the balance of such term and for any term of renewal or extension of such timeshare interest to the extent that such rights are enforceable under applicable nonbankruptcy law.

(B) If the timeshare interest purchaser retains its rights under Subparagraph (A), such timeshare interest purchaser may offset against the moneys due for such timeshare interest for the balance of the term after the date of the rejection of such timeshare interest, and the term of any renewal or extension of such timeshare interest, the value of any damage caused by the nonperformance after the date of such rejection, of any obligation of the debtor under such timeshare plan, but the timeshare interest purchaser shall not have any right against the estate or the debtor on account of any damage occurring after such date caused by such nonperformance. 11 U.S.C. §365(h).
Thus, if the lease is rejected by a bankrupt landlord, the tenant may elect to treat the lease as terminated or may retain possession of the leased premises for the balance of the current term plus any renewal or extension terms the tenant could have exercised without the landlord’s consent. If the tenant retains possession of the premises after a rejection, the tenant has no right to force the landlord or trustee to provide services or perform the landlord’s obligations promised under the lease but can offset damages incurred by any such failure and occurring after the rejection against future rents reserved under the lease. The tenant is not entitled to any claim against the debtor for damages arising after the rejection. In a situation such as the type of net lease typically used in sale and leaseback financing in which the landlord has few, if any, continuing obligations, the rights of the tenant should not be materially affected by a rejection if the tenant elects to stay in possession. See legislative history of 11 U.S.C. §365(h) and Patrick A. Murphy, CREDITORS’ RIGHTS IN BANKRUPTCY §9.16 (2d ed. 2002).

A problem that plagued landlord bankruptcies under former law was resolved in the 1978 reformation of the Bankruptcy Code. In the much-discussed In re Freeman, 49 F.Supp. 163 (S.D.Ga. 1943), the court found that in an arrangement proceeding under Chapter XII of the old law, the rent under a rejected lease could be adjusted upward in order to assist in the landlord-debtor’s rehabilitation. This decision was followed by some courts (In re Schnabel, 612 F.2d 315 (7th Cir. 1980), rejected by others (In re Garfinkle, 577 F.2d 901, 904 n.4 (5th Cir. 1978)), and criticized by commentators (Lawrence P. King ed., COLLIER ON BANKRUPTCY §547.11[2][e] (15th rev. ed. 2005); John J. Creedon and Robert M. Zinman, Landlord’s Bankruptcy: Laissez Les Lessees, 26 Bus.Law. 1391 (1971)). There was concern that the rationale of Freeman might well apply to arrangement proceedings under Chapters X and XI of the old bankruptcy law. Section 365(h) of the current Bankruptcy Code resolved this issue if the tenant remains in possession after the landlord or its trustee rejects the lease. In In re Stable Mews Associates, 35 B.R. 603 (S.D.N.Y. 1983), in accord with the Bankruptcy Code, the court refuted the Freeman and Schnabel opinions and held that under §365(h) the rent owed by the tenant to the bankrupt landlord after rejection should remain the rent stated in the lease. See also Carlton Restaurant, Inc. v. TM Carlton House Partners, Ltd. (In re TM Carlton House Partners, Ltd.), 97 B.R. 819, 823 (E.D.Pa. 1989); In re Flagstaff Realty Associates, 60 F.3d 1031 (3d Cir. 1995).

In addition, a seller-tenant should consider the risk that the following traditional legal doctrine could be applied to the sale and leaseback transaction: “Instruments executed at the same time between the same contracting parties within the course of a single transaction will be construed together.” See, e.g., Wipfli v. Bever, 37 Wis.2d 324, 155 N.W.2d 71 (1967). This principle was applied by the Wisconsin Supreme Court in Harris v. Metropolitan Mall, 112 Wis.2d 487, 334 N.W.2d 519 (1983). In that case, Metropolitan Mall, a real estate partnership, built a shopping center in Madison, Wisconsin, and subsequently entered into a sale and leaseback transaction with Harris. After 15 months, Metropolitan Mall, as seller-tenant, defaulted under the lease with Harris, the buyer-landlord, who then sued for the unpaid rent and, in addition, sought restitution of the property and cash he had already paid on the purchase price.

The Wisconsin Supreme Court agreed with the buyer-landlord, taking the position that the sale and leaseback were parts of a single transaction. In effect, the breach of the lease was a breach of the total sale-leaseback transaction, and the appropriate remedy for the buyer-landlord was the recovery of his total investment, not just the unpaid rent under the lease. As in other
breach-of-contract lawsuits, the buyer-landlord was entitled to receive as damages his expected profit. To reduce the likelihood of this outcome, seller-tenants should always require language in the sales contract and the lease that explicitly provides that the sale and the lease are independent and completely separate transactions and that a default under one gives no remedy with regard to the other.

The individual guarantors on the lease in *Harris* assumed personal liability to pay the buyer-landlord “all damages that may arise in consequence of any default by the tenant under such lease.” Again, the Wisconsin Supreme Court viewed the sale and leaseback as one transaction and ruled that the guaranty included a right to restitution under the contract. It should be noted that the guaranty was broadly worded and did not limit the obligation of the guarantors to lease-related damages. Lease guarantors in sale and leaseback transactions should always require language in the guaranty explicitly limiting their liability only to damages under the lease. See generally *Classic Cases: Canceling a Sale-Leaseback Transaction*, 29 Real Est. L. Rep. 8 (2000).

F. [5.7] Disadvantages to Buyer-Landlord

Investment in land and buildings is not as liquid and as readily disposable as investments in debt obligations secured by mortgages. In addition, a sale and leaseback investment is not as readily divisible as investments in bonds or preferred stock.

While a landlord may get the property back more quickly in a tenant’s bankruptcy and the tenant’s rejection of the lease than would a mortgagee in a debtor’s bankruptcy, if there are substantial assets in the estate, the landlord does not have rights equivalent to those of a mortgagee if the value of the recovered property does not equal the amount of the landlord’s original investment not then returned through rent payments. Future rent (including rights to participate in future net cash flow or proceeds of financing of the leasehold estate through the vehicle of additional rent) is generally not regarded as a debt so that the landlord, unlike a mortgagee, cannot accelerate the entire balance of the unpaid rent in the event of a bankruptcy arrangement or reorganization. Drafters of long-term leases have used various devices to attempt to create a provable debt in the event of a tenant’s default, e.g., by specifying the fixed rental for the entire term of the lease in a lump sum, but payable in installments. Nevertheless, if the lease is rejected, the landlord’s damages are limited to the greater of one year’s rent or 15 percent of the rent for the remaining term of the lease (not to exceed three years) in the event of a straight bankruptcy. 11 U.S.C. §502(b)(6).

One possible agreement may provide assistance to the landlord in the face of a tenant’s lease rejection. The legislative history of 11 U.S.C. §502(b)(6) (formerly 11 U.S.C. §502(b)(7)) contains extensive discussions of lease financing transactions. The legislative history indicates that if

the lease in fact involves a sale of real estate and the rental payments are in substance the payment of the principal and interest on a secured loan . . . . the lessor’s claim should not be subject to the §502(b)(6) limitation. The concept of a lease as a hidden security device is well-developed in the Uniform Commercial Code.
(UCC) and in case law thereunder, but the UCC applies to personal property transactions, while §502(b)(6) applies solely to real estate. Patrick A. Murphy, CREDITORS’ RIGHTS IN BANKRUPTCY §5.06, p. 5-12 (2d ed. 2006), citing 124 Cong. Rec. 11,093, 17,410 (1978).


The difference in position between a landlord of a bankrupt tenant and a mortgagee of a bankrupt borrower becomes less significant in the case of a nonrecourse loan or when there are insufficient assets in the bankrupt estate to pay a deficiency judgment. In either of these cases, the mortgagee will also be restricted solely to its remedies against the mortgaged property.

The Bankruptcy Code negates certain lease provisions that the landlord may have included in the lease to protect its position. Under the Bankruptcy Code, “ipso facto” clauses (which make bankruptcy, arrangement proceedings, etc., filed by the tenant under federal law an event of default) are rendered invalid. 11 U.S.C. §365(e). In addition, notwithstanding any provision in the lease prohibiting or restricting the tenant’s right of assignment, a debtor-tenant or trustee may assign the lease to a new tenant if the lease is assumed, the tenant’s past defaults are cured, damages from such default are compensated, or adequate assurances of such compensation are given and adequate assurance of future performance by the assignee of the lease is provided. 11 U.S.C. §§365(b)(1), 365(f)(1), 365(f)(2). In the case of leases of premises in a shopping center, the adequate assurances are described in detail. 11 U.S.C. §365(b)(3). Thus, a landlord may find itself dealing with a tenant other than a party the landlord originally bargained with and legally bound to that new tenant under the terms of the lease.

The question of the economic value of a buyer-landlord’s reversion in the property is the subject of much speculation. On its face, the buyer-landlord seems to be getting a windfall by its succession to the reversion. If, however, the lease is for a significantly long term and the improvements are constructed at the beginning of the lease term and not replaced during the term, the value of the improvements on the land at the end of the lease term may have substantially depreciated, and in fact the buyer-landlord may incur substantial expense in demolishing the improvements.

Difficulties for the buyer-landlord could arise if the sale-leaseback transaction is deemed to be an equitable mortgage or a disguised joint venture, whether in a state court proceeding or if the seller-tenant files for bankruptcy. Aside from the tax consequences, if the transaction is found to be an equitable mortgage, the buyer-landlord would have greater difficulty in realizing on its “security” since the usual rights a mortgagee builds into mortgage instruments in the event of a borrower’s default, such as a waiver of the borrower’s right of redemption, will be missing. In addition, as a joint venturer, the landlord (who has been recharacterized as a joint venturer) may be jointly and severally liable for the debts of the venture owed to those parties. PCH Associates v. Liona Corp. (In re PCH Associates), 55 B.R. 273 (Bankr. S.D.N.Y. 1985), aff’d, 60 B.R. 870 (S.D.N.Y.), aff’d, 804 F.2d 193 (2d Cir. 1986). If the transaction is found to be a joint venture, many of the devices that would be built into a joint venture agreement to protect a passive

III. AGREEMENT OF PURCHASE AND SALE

A. [5.8] Commitment

Unless the parties have agreed on the precise form of the lease so that a specimen can be attached to the contract as an exhibit, a formal contract of purchase and sale serves little purpose. Such a contract might well be held not to be specifically enforceable (except perhaps as an agreement of the parties to negotiate a lease in good faith) because of uncertainty as to the form of the lease, even if certain of the basic terms are spelled out in the contract. Frequently, however, the parties wish to evidence their intent without waiting to have all of the details of the lease spelled out. This condition prevails especially if the transaction contemplates the construction of improvements by the seller-tenant that will be sold to the buyer-landlord upon completion of construction. Under these circumstances, the seller-tenant will find it helpful to have a so-called commitment or letter of intent from the buyer-landlord for the purchase of the property and to use this to obtain interim financing.

In general, commitments can fall into one of three categories: (1) a binding contract that the parties can enforce with respect to the transaction outlined in the commitment (see Quake Construction, Inc. v. American Airlines, Inc., 141 Ill.2d 281, 565 N.E.2d 990, 152 Ill.Dec. 308 (1990)); (2) not a contract to consummate the transaction outlined in the commitment, but rather a contract creating an obligation of the parties to negotiate in good faith (see Berco Investments, Inc. v. Earle M. Jorgensen Co., 861 F.Supp. 705 (N.D.Ill. 1994)); or (3) a simple term sheet outlining the discussions of the parties but creating no obligation either to consummate the transaction or even to negotiate in good faith (see Philmar Mid-Atlantic, Inc. v. York Street Associates II, 389 Pa.Super. 297, 566 A.2d 1253 (1989)). Which category a commitment or letter of intent falls under is a question of the intent of the parties as determined by a court.

The parties to a commitment must decide whether they wish to impose on themselves an obligation to negotiate in good faith, execute a binding contract, or create no obligations whatsoever. The answers to these questions should be clearly stated in any written commitment. Thus, for example, if the parties wish to impose an obligation to continue negotiations in good faith and nothing more, the commitment should contain language similar to the following:

This document contains an enumeration of certain business understandings that the parties have reached that may become part of a contract if the parties eventually enter into such a
contract. Standing on its own, however, this document is not intended to impose any obligations whatsoever on either party, except for the sole exception of an obligation to bargain in good faith based on the business understandings enumerated herein. The parties do not intend to be bound by any other agreement until both agree to and sign a formal written contract, and neither party may reasonably rely on any promises inconsistent with this paragraph. Until such a definitive agreement is finalized, approved by the respective boards of directors (which approval shall be in the sole subjective discretion of the respective boards of directors), and properly executed, neither party shall have any obligation to the other (whether under this commitment or otherwise), with the sole exception of a legal duty as aforesaid to continue negotiations in good faith toward the goal of reaching such a definitive agreement. This paragraph supersedes all other conflicting language in this document.

A properly drafted commitment can protect both sides of the transaction, and the commitment can form a basis by which either party may resist any attempt by the other to vary the basic terms of the transaction contained in the commitment. In addition, the commitment can form the basis of an action for damages against the buyer-landlord if, during the course of negotiations on the lease term, the buyer-landlord were to act in obvious bad faith in refusing to agree on the terms of the lease. See A/S Apothekernes Laboratorium for Specialpræparerer v. I.M.C. Chemical Group, Inc., 873 F.2d 155 (7th Cir. 1989). The seller-tenant’s burden of proof necessary to establish the unreasonableness of the buyer-landlord is, however, a substantial one and difficult to meet. Sonnenblick-Goldman Corp. v. Murphy, 420 F.2d 1169, 1173 (7th Cir. 1970); Boston Road Shopping Center, Inc. v. Teachers Insurance & Annuity Association of America, 13 A.D.2d 106, 213 N.Y.S.2d 522, 527 (1961), aff’d, 11 N.Y.2d 831 (1962). At least one court has found specific performance to be an appropriate remedy for a breach of a commitment. First National State Bank of New Jersey v. Commonwealth Federal Savings & Loan Ass’n, 610 F.2d 164 (3d Cir. 1979) (commitment for permanent mortgage loan financing specifically enforced). See generally Empro Manufacturing Co. v. Ball-Co Manufacturing, Inc., 870 F.2d 423 (7th Cir. 1989).

A refundable commitment fee or standby fee is often paid by the seller-tenant just as in a mortgage loan commitment. This fee is refunded upon the consummation of the transaction. If the seller-tenant fails to comply with the requirements of the commitment within the time period provided, the commitment fee can be retained by the buyer-landlord to pay its liquidated damages. See, e.g., Boston Road Shopping Center, supra, in which, in a mortgage commitment case, the court held the lender could retain the commitment fee paid by the borrower. A condition of the commitment requiring that certain occupancy leases must be in a form satisfactory to the lender did not render the commitment an illusory contract since the court would impose a reasonable standard on the exercise of the lender’s judgment. See also Sonnenblick-Goldman, supra, 420 F.2d at 1173, another case dealing with the enforceability of a mortgage commitment in which the court, in finding that a lender cannot act arbitrarily in demanding the creation of loan reserves, quoted with approval the following:

The fact that the parties have left some matters to be determined in the future should not prevent enforcement, if some method of determination independent of a party’s mere “wish, will, and desire” exists, either by virtue of the agreement itself or by commercial practice or other usage or custom. This may be the case, even
though the determination is left to one of the contracting parties, if he is required to make it "in good faith" in accordance with some existing standard or with facts capable of objective proof. Corbin on Contracts, §95, pp. 401 – 402; §97, pp. 425 – 426.

Presumably, this same standard would apply in the case of a commitment issued in a sale and leaseback transaction.

Often, commitments contain a time limit for agreement on the form of lease so that, in case of failure of the parties to agree on a form, the commitment will expire by its terms. While such a provision is often inserted by a buyer-landlord in an attempt to pressure the seller-tenant into agreeing to the terms of a lease within a reasonably short period, such a provision can turn into a double-edged sword, working toward the detriment of the buyer-landlord. If the form of lease is not agreed on within the required time period, the seller-tenant is then presented with a means by which the commitment can be terminated and, possibly, the return of a standby deposit demanded. In order to avoid such a problem, the buyer-landlord's commitment should contain a provision empowering the buyer-landlord, at its sole discretion, either to extend by written notice to the seller-tenant the period of time during which the form of lease can be agreed on (thereby obviating the need to obtain the seller-tenant’s consent to such an extension) or to terminate the commitment and retain the standby deposit.

B. [5.9] Contract

If a contract is used, either when the form of lease has been finalized or because the parties elect not to use a commitment (notwithstanding the problems raised in §5.8 above), the contract will most likely be in the usual form of a purchase and sale contract commonly used in the location of the property, with a condition that the lease be executed and delivered concurrently with and as a condition of the closing. Usually, any requirement for prorations is eliminated since any adjustments between buyer and seller, which would normally be part of a sale, would be offset by adjustments between the landlord and tenant under the lease. For example, no point is served by an allowance of accrued real estate taxes by the seller to the buyer since it will become the seller's obligation as tenant under the net lease to pay the very same taxes for which it will have given a credit.

C. [5.10] Basic Terms of Commitment and/or Contract

While, of course, each transaction will be subject to the terms agreed on by the parties and tailored to the basic transaction, the following is a summary of some of the basic types of terms that could be expected to be found in a commitment or contract for a sale and leaseback transaction:

1. If the buyer is an institutional investor, the commitment and even any final contract entered into will frequently contain broad provisions requiring documents; title matters; evidence of compliance with zoning, building, EPA, and flood control ordinances and regulations; and related matters to be generally acceptable to the buyer and to be subject to unqualified approval by the buyer's counsel. Sometimes there is a requirement for an opinion by the seller's counsel as
well. Some institutional buyers also require the seller to make various representations and warranties, particularly if the buyer is relying on the credit standing of the seller as a prospective tenant. As long as the conditions and requirements are enunciated in such a fashion that a reasonable standard can be applied to determine whether they have been complied with, these conditions should not render the commitment or contract illusory. Sonnenblick-Goldman Corp. v. Murphy, 420 F.2d 1169 (7th Cir. 1970); Boston Road Shopping Center, Inc. v. Teachers Insurance & Annuity Association of America, 13 A.D.2d 106, 213 N.Y.S.2d 522 (1961), aff'd, 11 N.Y.2d 831 (1962). See §5.9 above.

2. If a purchase is to be made by an institutional investor, the contract or commitment will, as in the case of mortgage loans, usually require the seller to bear all expenses, including the buyer’s out-of-pocket expenses and attorneys’ fees.

3. If the transaction does not involve the sale of an existing project, the contract or commitment will most likely include the obligation of the buyer or the seller (depending on the nature of the transaction) to construct certain improvements on the land in accordance with agreed-on plans and specifications. If title to the improvements is to be vested in the landlord during the term of the lease, construction of these improvements may be either the tenant’s or the landlord’s obligation, depending on the agreement of the parties. If title to these improvements is to be vested in the tenant, with the landlord receiving only the title to the land and a reversionary interest in the improvements, the seller-tenant will most likely be required to complete the improvements.

4. The date of closing will depend on the structure of the transaction. If the sale and leaseback involves an existing, completed project, the parties can close as soon as the form of lease is agreed on and the other conditions of closing are met. If, however, the sale involves vacant land only on which improvements are to be constructed, the party not charged with the obligations of construction will not want to close until it has been presented with suitable evidence that the improvements have been constructed in accordance with the agreement of the parties (such as an architect’s certificate of at least substantial completion and a certificate of origin).

5. Unless a so-called “New York style” closing is utilized by the parties, transactions are frequently closed through a deed and money escrow in which provision is made for a return of the buyer’s money if title fails, subject to the buyer’s reconveyance to the seller. A memorandum of lease setting forth the existence of the lease, its terms, and all options and contracts contained in the lease will often be deposited in the escrow to be recorded immediately after the deed from the seller to the buyer. This memorandum should impart constructive notice on third parties of the existence of the lease (Bezin v. Ginsburg, 59 Ill.App.3d 429, 375 N.E.2d 468, 16 Ill.Dec. 595 (1st Dist. 1978)), of any special agreements between the parties of which third parties should be placed on notice (e.g., no right of the tenant to subject the landlord’s reversion to a lien), and of any option or right in the tenant to purchase the landlord’s reversion (although some authorities contend that the mere possession of the demised premises by the tenant is sufficient notice of an option to purchase) (Robert T. Kratovil, Lease Draftsmanship: Problems of Lessees and Their Lenders, The Guarantor (Apr. 1970)). In order to remove any cloud on the title resulting from the
recording of the lease or of a memorandum of lease, the escrow frequently requires the deposit of a lease cancellation agreement, which the escrowee will record if the lease is terminated prior to the expiration of its scheduled term.

6. The buyer will generally require an ALTA Owner's Policy with special insurance against possible mechanics lien claims, rights of parties in possession, unrecorded easements and encroachments, and a current survey of the property showing all existing improvements. The seller may also obtain a policy insuring the leasehold estate and, if applicable, the separate estate in the improvements.

7. In some cases, the purchase price is not fixed but is to be based on the cost of construction of improvements with a certain dollar amount as a ceiling. An institutional investor also often requires that the price it pays be supported by a good appraisal whether or not the price is fixed.

If the contract price is flexible, the lease rental will often be stated in the commitment or contract in terms of a percentage of the purchase price. When the lease itself is actually executed, the dollar amount of rental is inserted since, at the time of execution, the purchase price will usually have been determined. In some instances, the lease itself contains a formula rather than a dollar figure for the amount of rent. In these circumstances, once the amount of rent has been determined and agreed on, it is advisable for the parties to execute a supplement to the lease, or at least an informal writing, setting forth the dollar amount of rental that the parties have agreed on. Note, however, the problems raised in §5.11 below with respect to commitments or leases stating rent as a formula based on the amortization of the purchase price plus an interest factor.

8. The contract will require evidence that if the seller is a corporation, its board of directors has duly authorized the sale. In addition, if the sale involves all or substantially all of the assets of a corporate seller, evidence of the approval of the requisite number of the corporation's shareholders must be provided. This might cause problems if a large number of dissenting shareholders express their disapproval of the sale and leaseback transaction and demand payment of the fair value of their shares pursuant to statute. 805 ILCS 5/11.60, 5/11.65, 5/11.70; William L. Cary, Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations, 62 Harv.L.Rev. 1, 16 (1948). If the buyer is a corporation, the seller may require evidence that the buyer's board of directors has authorized the lease of the premises after closing. If either party is a partnership or limited liability company, evidence may be required (perhaps in the form of an attorney's opinion) that the partner executing the required instruments on behalf of the partnership or limited liability company has the requisite authority to do so.

D. Equitable Mortgages; Disguised Joint Ventures

1. [5.11] Avoiding Finding of Equitable Mortgage

As stated in §5.7 above, one danger inherent in an improperly structured sale and leaseback transaction is that a court will find the transaction not to be a sale and lease at all but rather a disguised loan of money with the buyer-landlord's rights in the property constituting an equitable mortgage. Apart from the serious tax consequences of such a finding, both to the buyer-landlord
and to the seller-tenant, which are beyond the scope of this handbook, the landlord-mortgagee is, in the case of default, faced with the problems of foreclosing a mortgage without the benefit of a waiver of the rights of redemption and without the benefit of the various covenants usually contained in a mortgage and applicable in the case of default (e.g., an agreement that the mortgage secures all money expended by the mortgagee to cure the mortgagor’s default, notwithstanding that the total amount secured by the mortgage exceeds the face amount of the note).

Whether a deed or other conveyance that appears to be absolute on its face is, in fact, merely given as security for a loan depends on the facts and circumstances of the particular transaction that evidence that the parties intended the transaction to be a financing instead of a conveyance and lease. A seller-tenant or other party (e.g., a creditor of the seller-tenant seeking to redeem) alleging that, for other than tax purposes, a sale was really an equitable mortgage must produce clear, satisfactory, and convincing evidence of the intent of the parties. Parol evidence is admissible. In determining whether a sale is really a loan secured by an equitable mortgage, Illinois courts have considered factors such as the ratio of consideration paid to fair market value of the property (e.g., if the value of the property “purchased” was substantially in excess of the consideration paid, it evidences a loan instead of a purchase), the actions of the “tenant” with respect to the property (e.g., if the seller-tenant improves the property although not required to do so by the lease), the existence of an option to repurchase the property at an amount that does not reflect the fair market value of the property, and the agreement of the seller-tenant to repay a fixed sum plus interest within a fixed time (which obligation could be read into improperly drawn rent-payable provisions). Leeds & Lippincott Co. v. United States, 276 F.2d 927 (3d Cir. 1960) (per curiam); Commissioner of Internal Revenue v. F. & R. Lazarus & Co., 101 F.2d 728 (6th Cir.), aff’d, 60 S.Ct. 209 (1939); Wilkinson v. Johnson, 29 Ill.2d 392, 194 N.E.2d 328 (1963). See generally UMET Trust v. Santa Monica Medical Investment Co., 140 Cal.App.3d 864, 189 Cal.Rptr. 922 (1983).

Another problem that may result in many jurisdictions from the finding of an equitable mortgage and concomitant loan is that the transaction is usurious. Often, the percentage rate of return built into a sale and leaseback transaction (or the combined rate or return from the lease and the interest paid by the seller-tenant as leasehold mortgagor to the buyer-landlord as leasehold mortgagee pursuant to a separate leasehold mortgage made as part of the whole transaction) will exceed the interest rate permissible under applicable state law. Since, however, Illinois has both the business loan exception to the usury laws (815 ILCS 205-5/4(1)(c)), which sets no limits on interest payable in connection with any loan made for a business purpose, and an exemption from maximum interest limitations for loans “secured” by real estate (815 ILCS 205/4(1)), this problem will not exist in any sale and leaseback transaction covered by Illinois law. If Illinois law does not govern the transaction, the problem of usury must be seriously considered.

During the 1972 session on sale and leaseback financing held in New York City under the auspices of the Practising Law Institute, one panelist suggested the following ground rules used by one institutional investor in order to avoid having a sale and leaseback construed as a mortgage:
a. Avoid characterizing the transaction as a mortgage transaction; contracts, commitments, and leases should not use such terms as “interest rate” and “amortization.” Avoid side agreements that make a transaction look like a loan. See Sun Oil Co. v. Commissioner of Internal Revenue, 562 F.2d 258, 266 (3d Cir. 1977), cert. denied, 98 S.Ct. 2845 (1978), a tax case, in which the court was influenced by the use of such mortgage loan terms as “principal,” “interest,” “standby fees,” and loan “commitment fees.”

b. Have the lease look like a lease and not like a bond or a mortgage.

c. Avoid great disparity between the purchase price and the actual value of the property. The value of the property should be supported by impartial evidence, such as an appraisal. In addition, the rental should, if possible, reflect the fair market value of the property and not simply an amortization of the purchase price plus an “interest factor.”

d. Avoid granting the seller-tenant an option to repurchase the property for substantially less than the fair market value of the property at the time of the repurchase.

e. Avoid any requirement that the seller-tenant must repurchase the property at the end of the lease term. In addition, avoid making the term of the lease — the basic term and all option terms granted to the seller-tenant — so much shorter than the useful life of the improvements that the seller-tenant will be obligated to exercise an option to repurchase or to negotiate with the buyer-landlord for a right to repurchase in order to avoid losing much of the remaining usable life of the improvements. Lyn R. Oliensis, SALE AND LEASEBACK FINANCING, p. 92, et seq. (PLI, 1973). See also the transcript of the program held June 20 and June 21, 1969, Sale and Leaseback Financing (PLI, 1969).

In addition, a number of judicial opinions arising in the context of whether, for tax purposes, a sale and leaseback transaction is a true sale and lease give guidance regarding the characteristics necessary to avoid the treatment of a sale and leaseback as a financing arrangement. In Sun Oil Co., supra, 562 F.2d at 268 — 269, the court focused on the “attributes of ownership.” The important factors delineated by the Sun Oil court include the following:

Risks and responsibilities. The burdens and risks on the buyer-landlord and seller-tenant should be consistent with customary substantive bargains made in the marketplace between landlords and tenants.

Benefits of the transaction. Granting the seller-tenant broad powers with regard to benefits traditionally reserved to the owner of the property will be deemed as benefits characteristic of ownership of property rather than those of a leasehold.

Rentals. Rental should reflect the fair rental value of the property. In negotiation and documentation, the use of terms common in mortgage financing and not traditional in a landlord-tenant relationship should be avoided.
Options to repurchase. The repurchase provision should not be geared to the unamortized principal advanced by the "buyer-landlord." See §§5.56 and 5.57 below for a discussion of the "equitable mortgage" problem in the context of repurchase options. See also Frank Lyon Co. v. United States, 435 U.S. 561, 55 L.Ed.2d 550, 98 S.Ct. 1291 (1978).

While these cases deal with the tax treatment of sale and leaseback transactions, the consideration by the courts of the various characteristics of a transaction they found persuasive is instructive.

Of course, the parties to a sale and leaseback transaction may not be able to comply with all of the foregoing guidelines and still have the transaction make business sense. An effort should be made, however, to comply with as many of the guidelines as possible.

2. [5.12] Avoiding Partner or Joint Venturer Relationship

In one type of sale-leaseback transaction currently in vogue, if the buyer-landlord receives fixed rent and also participatory rent equal to a part of the net cash flow and proceeds of sale and refinancing from the seller-tenant's property, a buyer-landlord must take care lest a court reconstrue the buyer-landlord's relationship with the seller-tenant as one of partners or joint venturers.

The basis of such a finding would be that the buyer-landlord has a proprietary interest in the seller-tenant's property through ownership of the land, is involved in the conduct of the seller-tenant's business, and shares in the profits of the enterprise because of its participation in the seller-tenant's profit via the payment of participatory ground rent. Such a finding would leave the buyer-landlord open to a third-party claim arising from the seller-tenant's actions and to a possible reallocation of the tax benefits arising from the transaction. In addition, if the buyer-landlord is found to be a joint venturer, it may lose its rights as a landlord to terminate the lease and regain possession and may be forced to sue in equity for an accounting.

The danger that the buyer-landlord might be found to be a partner or joint venturer with the seller-tenant is increased as the buyer-landlord inserts in the lease documents provisions that give the buyer-landlord the types of safeguards normally desired by one interested in the success of an enterprise. The buyer-landlord has a definite interest in seeing that the seller-tenant's business is managed in such a way as to maximize net cash flow and that any sale or refinancing is done in such a way as to maximize proceeds. The greater these amounts, the greater the amount of participatory rent the buyer-landlord receives. However, the more controls the buyer-landlord builds into the ground lease in order to achieve the goal of maximizing net cash flow and proceeds of sale and refinancing, the more fuel the buyer-landlord provides to the argument that it has stepped beyond the landlord's role and into the role of a partner or a joint venturer.

Arguments can be made against holding the buyer-landlord to be a partner or joint venturer. First of all, many commercial landlords, especially of tenants in the retail business, now share in their tenant's profits via percentage rent. These commercial landlords, having an interest in the tenant's success, build in some control over the tenant's business via the lease. The buyer-landlord in a participatory lease of land only has similar interests and goals. Holding a buyer-
landlord of the land only to be a partner or joint venturer could open the door for all of these retail leases to be attacked. Second, most ground leases do not give the buyer-landlord real control over the operation of the seller-tenant’s business venture — a key element of a partnership or joint venture. Third, while the real investment incentive for the buyer-landlord in entering into the transaction may be its participatory features and not the fixed-rent payments, the buyer-landlord receives a certain bottom-line return whether or not the seller-tenant’s business is successful. The buyer-landlord gets the fixed rent during the lease term and generally the improvements at the end of the term regardless of whether the seller-tenant’s business is successful. Since the buyer-landlord’s return from the enterprise does not rest wholly on its success, the community of interest and the duty to share profits and losses, necessary for a partnership or joint venture, do not exist. Fourth, at least between the buyer-landlord and seller-tenant, the parties have knowingly chosen the lease format with its participatory features. The seller-tenant should not later be heard to argue that notwithstanding the lease format knowingly entered into, the transaction is indeed a partnership or joint venture. See, e.g., In re Kassuba, 562 F.2d 511 (7th Cir. 1977).

The buyer-landlord can take a number of preventive steps when entering into a sale-leaseback transaction in order to strengthen its arguments against a contention by the seller-tenant or a third party that the relationship is indeed a joint venture, partnership, or loan.

For example, in leases in which the amount of rent is determined at least in part by participation in the seller-tenant’s income from the property, the buyer-landlord should avoid acquiring controls of such a nature that the buyer-landlord could be deemed to be in joint control of the seller-tenant’s business. The buyer-landlord’s legitimate desire to maximize cash flow and the proceeds of any sale or refinancing can be accomplished largely by requiring the buyer-landlord’s approval of certain vital features of the enterprise that affect profitability (such as annual budgets) and by restricting actions of the seller-tenant that favor the seller-tenant to the detriment of the enterprise (such as making payment to the seller-tenant or a related entity of fees in excess of market prices). In this way, the buyer-landlord can justify limited controls as necessary to protect its interest in maximizing participatory rent without initiating actions and operating the business.

Second, the lease documents should contain a clear recital that the buyer-landlord and the seller-tenant are entering into a lease arrangement and not a partnership, joint venture, or loan; that the buyer-landlord would not have entered into the transaction if a partnership, joint venture, or loan would be the result; that the seller-tenant has been represented by experienced legal counsel who has advised the seller-tenant of the rights and duties of a seller-tenant; and that the seller-tenant will not raise a partnership, loan, or joint venture defense if the buyer-landlord subsequently seeks to enforce legal rights as lessor. If the parties to the transaction are sophisticated and represented by competent counsel, such a recital should help a court conclude that the seller-tenant is bound by the format the seller-tenant knowingly chose and is estopped from raising such defenses.

Third, to ensure the buyer-landlord at least secured creditor status if the transaction is recharacterized as a loan in bankruptcy and to weaken any argument by a third party that a loan or joint venture arrangement exists, a duly recorded memorandum of lease should spell out clearly
the nature of the lessor-lessee relationship. If the transaction is recharacterized as a loan, the buyer-landlord may be regarded as an unsecured creditor in the absence of appropriate recorded documents. Similarly, escrow arrangements in which title to the property is not conveyed immediately should be avoided. If the escrowee holds the title deed without recordation, the buyer-landlord cannot assert its title to the real estate against a bankrupt seller-tenant standing in the trustee’s shoes. 11 U.S.C. §544; Capital Center Equities v. Estate of Gordon (In re Capital Center Equities), 137 B.R. 600 (Bankr. E.D.Pa. 1992).

Fourth, the parties should avoid characterizing the transaction as a mortgage transaction. Contracts, commitments, leases, and other documents should not use loan terms such as “interest rate” and “amortization.” Side agreements that cause a transaction to look like a loan should be avoided.

Fifth, the parties should avoid great disparity between the purchase price and the actual value of the property. Any difference should be supported by impartial evidence, such as an appraisal. In addition, the rental should seek to reflect the fair market value of the property and not simply an amortization of the purchase price plus an interest factor.

Sixth, the parties should avoid granting the seller-tenant an option to repurchase the property for substantially less than the fair market value of the property at the time of the repurchase.

Seventh, the parties should avoid any requirement that the seller-tenant must repurchase the property at the end of the lease term. In addition, they should avoid making the term of the lease — the basic term and all option terms granted to the seller-tenant — so much shorter than the useful life of the improvements that the seller-tenant effectively will be compelled to exercise an option to repurchase or to negotiate with the buyer-landlord for a right to repurchase to avoid losing much of the remaining usable life of the improvements.

Finally, the adverse effects to the buyer-landlord resulting from a successful attempt by a bankrupt seller-tenant to recharacterize a sale and leaseback transaction might be substantially reduced through the use of credit enhancement. The obligations of the seller-tenant could be backed by a guarantee, letter of credit, or other type of credit enhancement. In the event of a bankruptcy of the seller-tenant and a successful attempt to recharacterize the transaction, the buyer-landlord would have recourse to the credit enhancer to the extent the buyer-landlord is not made whole through the bankruptcy proceedings.

E. Forms

1. [5.13] Provision in Contract to Which Copy of Lease Is Attached as Exhibit

Concurrently with the delivery of the Deed and as an integral part of this transaction, Buyer, as landlord, and Seller, as tenant, shall execute and deliver a lease substantially in the form attached to this contract and marked [Exhibit A], with the blanks to be completed appropriately in accordance with the provisions of this contract.
NOTE: The time of commencement of the lease, original term, provisions for any fractional month, formulae for determining dollar amount of rent, and like matters, if left blank in the lease attached as an exhibit, and any other blanks in the lease will then have to be provided for appropriately in the body of the contract.

2. [5.14] Provision in Commitment or Contract in Which Form of Lease Has Not Yet Been Agreed On

Concurrently with the delivery of the Deed and as an integral part of the transaction, Buyer, as landlord, and Seller, as tenant, shall execute a lease in accordance with the provisions of this document in such form as the parties shall mutually agree on. In case the parties shall not have agreed on a form of lease within _____ days from the date of this document or by such further date as Buyer may extend this period by written notice to Seller (but not beyond _____ days from the date of this document), this agreement shall terminate and be of no further force and effect.

NOTE: In some instances, depending on the relationship of the parties, it will be appropriate to provide that if the parties do not agree on a form of lease, the buyer will retain a deposit as liquidated damages or the seller will retain the earnest money as liquidated damages unless the failure to reach an agreement is the result of the failure of the party retaining the deposit or earnest money to act in good faith.

IV. THE LEASE

A. [5.15] In General

The lease will follow the form of a typical long-term net lease but will not often be very favorable to the buyer-landlord. One of the penalties the seller-tenant must pay for the financial advantages of the transaction is that the form of lease will necessarily minimize the buyer-landlord’s risks of loss to the greatest extent possible and will confer broad remedies on the buyer-landlord for the seller-tenant’s defaults. As discussed in §§5.11 – 5.12 above, the buyer-landlord must exercise great care to see that the lease retains the basic characteristics of a lease and does not become a mortgage, bond indenture, or disguised joint venture.

B. Net Lease

1. [5.16] Characteristics of Net Lease

The lease will be a so-called “net lease.” In common parlance, it will sometimes be characterized as “net-net” or even “net-net-net.” While these terms defy definition, their implication is clear. The seller-tenant almost invariably agrees to pay all taxes and assessments that are unpaid and have accrued at the commencement of the term and that continue to accrue during the term of the lease; to carry, at seller-tenant’s expense, various kinds of insurance for the benefit of the buyer-landlord, including fire and extended coverage, boiler and other types of casualty insurance, and liability insurance; and to bear all costs of maintenance and repair.
Frequently, the lease contains a general statement of the intent of the parties that it shall be a net lease so that the buyer-landlord will receive the fixed rent and any additional rent to which it may be entitled by reason of the success of the project without reduction or diminution of any kind. This provision is, of course, merely declaratory, and the lease always contains detailed provisions that spell out the various obligations of the seller-tenant to render the lease a net lease. See §5.39 below on the non-abatement of rent following destruction of the improvements by fire or other casualty and following partial condemnation.

2. [5.17] Forms of Provisions To Establish Intention That Lease Will Be Net Lease

This provision is to be coupled with specific provisions for the seller-tenant to pay taxes and insurance premiums, maintain the property, comply with ordinances, etc. See §§5.61 and 5.65 below for examples of these types of provisions.

1. The Basic Rent shall be absolutely net to Landlord so that this Lease shall yield, net, to Landlord the specified Basic Rent in each year during the term of this Lease, and so that every item of expense of every kind, except as otherwise provided in this Lease, for the payment of which Landlord is, shall, or may be or become liable by reason of its estate or interest in the Demised Premises or of any rights or interests of Landlord in, under, or arising from the ownership, leasing, operation, or management of the Demised Premises or by reason of or in any manner connected with the maintenance, repair, rebuilding, remodeling, renovation, use, or occupancy of the Demised Premises or any buildings or improvements on those Premises shall be borne by Tenant. Except as otherwise specifically provided, damage to or destruction of any portion or all of the buildings, structures, and fixtures on the Demised Premises by fire, the elements, or any other cause whatsoever, whether with or without fault on the part of Tenant, shall not terminate this Lease or entitle Tenant to surrender the Demised Premises or entitle Tenant to any abatement of or reduction in the rent payable or otherwise affect the respective obligations of the parties to this provision, any present or future law to the contrary notwithstanding. If the use of the Demised Premises for any purpose should at any time during the term of this Lease be prohibited by law or ordinance or other governmental regulation or prevented by injunction or if there is any eviction by title paramount, this Lease shall not, except as otherwise specifically provided, be thereby terminated, nor shall Tenant be entitled by reason thereof to surrender the Demised Premises or to any abatement or reduction in rent, nor shall the respective obligations of the parties to this provision be otherwise affected.

2. The Basic Rent shall be paid to Landlord without notice, abatement, deduction, or setoff.

3. Tenant shall also pay without notice, abatement, deduction, or setoff, as additional rent, all sums, impositions costs, expenses, and other payments that Tenant in any of the provisions of this Lease agrees to pay. In the event of any nonpayment of any of the foregoing, Landlord shall have all the rights and remedies provided for by law in the case of nonpayment of the Basic Rent.

NOTE: See §5.65 below for a clause defining the “impositions.”
C. [5.18] Term of Lease

The lease is usually for a fairly long term. The minimum is usually 20 to 30 years. The seller-tenant is frequently given renewal options to extend the term up to as long as 80 to 90 years. As stated in §5.16 above, tax considerations are often important in determining the length of the term.

D. Rent

1. [5.19] Factors in Determining Amount of Rent

Basic rent in the typical sale and leaseback transaction is computed so that the buyer-landlord’s investment, with interest at a fixed rate at times slightly in excess of the prevailing market rate for mortgage loans, will be amortized over the primary term of the lease. In some instances, the basic rental is reduced during the renewal option periods since the original investment plus interest has been returned. In this respect, the lease in a sale and leaseback transaction is different from the usual ground lease. Under the ground lease not involving a sale and leaseback, the ground rental the tenant is paying represents a fair market rental for the use of the land on which the tenant has erected or will erect the building. Since the land is not subject to physical depreciation, ground lease rent will most likely remain constant throughout the term of the ground lease (or will be subject to periodic upward adjustments, based on reappraisals). In a sale and leaseback transaction, on the other hand, the basic rent is designed to return the buyer-landlord’s original investment plus interest so that it is possible for the seller-tenant to negotiate reduced basic rental payments during the extension terms. As discussed in §§5.11 – 5.12 above, great care must be taken in structuring the rent payments to avoid the appearance of a loan so that a court will not find the transaction to be, in fact, a loan secured by an equitable mortgage.

Some buyer-landlords, in an effort to maintain a constant fixed return in real money terms during an inflationary economy, require the seller-tenant to pay, in addition to the fixed rent, an “inflation hedge” of a portion of the gross income realized per annum by the seller-tenant from the property. Often, in computing the gross income figure, the seller-tenant is allowed to exclude any amounts collected from the occupancy tenants as a result of tax or escalation clauses. An alternative method of protecting the buyer-landlord’s return against dilution from inflation would be to require the seller-tenant to pay additional rent based on a cost-of-living escalation provision. In addition, in an effort to maintain a fixed return, a buyer-landlord may require the seller-tenant to reimburse the buyer-landlord for any state or local taxes imposed on the buyer-landlord by reason of the transaction (although perhaps this obligation might be found already in the rent absolute language set forth in §5.17 above). S. Douglas Weil, Land Leasebacks Move Up Fast as Financing Techniques, 1 Real Est.Rev., No. 4, pp. 65, 68 (1972).

In times of extremely high interest rates, investors have made sale and leaseback financing available for a consideration consisting of fixed rent below the then-current interest rates plus additional rent measured by net cash flow and proceeds of financing of the leasehold estate. This allows the seller-tenant to enter into the financing at a level of fixed cost that may be more manageable than the cash outlay that would be necessary to service conventional mortgage financing while still enabling the buyer-landlord, if the transaction is successful, to realize a
return substantially in excess of the lender’s return in conventional mortgage financing. See §5.5 above for a discussion of the bankruptcy ramifications of this device and §§5.11 – 5.12 above for a discussion of the danger that participation by the buyer-landlord in the “upside” may cause the financing to be deemed a disguised joint venture.

2. [5.20] Form of Provision for Additional Rental

Tenant further covenants and agrees to pay Landlord a portion of the net cash flow from the Property as Additional Rental. “Additional Rental” shall be paid by Tenant to Landlord monthly in the amount of _____ percent of net cash flow (as defined in this document) from the Property in excess of $_________. The term “net cash flow” shall mean all income received by Tenant from the operation of the Property, including, without limitation, all rents, use and occupancy fees, charges, and other income from or with respect to the Property and its operation; all proceeds of any condemnation of Tenant’s leasehold estate in the Property (that is not accompanied by a condemnation of Landlord’s interest in the Property); and all proceeds of any loan secured by the Tenant’s leasehold estate in the Property.

E. Insurance and Tenant’s Indemnification

1. [5.21] Liability and Dramshop Insurance

Even though the seller-tenant is in complete control of the property, the lease should require the seller-tenant to carry liability insurance in sufficient amounts and with adequate coverage, protecting the seller-tenant as owner of the leasehold estate and the buyer-landlord as owner of the fee and a reversionary interest in the improvements. Because of the pattern of constantly awarding greater judgments in litigation involving claims covered by liability insurance, a procedure should be built into the lease to provide for periodic increases of the limits of liability insurance — perhaps measured by cost-of-living increases.

In Illinois, where the sale or giving away of alcoholic liquors can subject the landlord to liability and the property to a judgment lien unless the landlord prohibits the tenant from selling and giving away alcoholic liquors (235 ILCS 5/6-21), the tenant should be required to carry dramshop insurance at all times when any alcoholic liquors may be sold or given away on the premises. This insurance must cover the interest of the landlord, the tenant, and any leasehold or fee mortgagee.

2. [5.22] Casualty Insurance

The seller-tenant should also be required to carry insurance against damage and destruction of improvements by fire and other casualty, naming the buyer-landlord and seller-tenant as insureds. Sometimes the lease requirement is for insurance for the replacement costs of the improvements above foundations, sometimes for the full insurable value, and other times for a stated percentage (usually 80 percent or 90 percent) of insurable value. In some instances, the requirement is couched in language requiring the seller-tenant to carry insurance in an amount sufficient to prevent the insured from being a coinsurer.
As a precaution that inflationary economic conditions might reoccur in the future, there should be a provision for periodic insurance appraisals, with coverage of casualty insurance policies being adjusted annually between appraisals to reflect increases in an appropriate cost-of-living index. Many appraisal companies, insurance companies, and insurance agents offer a service to calculate the annual increase in coverage.

Parties to a lease frequently overlook the fact that a stated amount of casualty insurance is only a maximum figure and that the loss for which the issuer will be liable (subject to this maximum) will be measured not by the face amount of insurance but by the actual depreciated value of the improvements. If the parties or either of them wishes to create a sufficient fund to pay for the replacement of depreciated improvements, the lease must require the seller-tenant to carry a replacement cost form of insurance.

Blanket or multiple location insurance is quite common, especially for large corporate tenants having property rights in many scattered locations. While such insurance would be acceptable if otherwise satisfactory to the buyer-landlord, the buyer-landlord should be certain that the policy does not contain a coinsurance provision based on the value of all of the seller-tenant’s locations covered by the policy. If such a clause is contained in the policy and the total coverage on all properties does not equal the required percentage of the total value of all the seller-tenant’s property, the amount of insurance payable in the event of a loss to the sale-leaseback parcel could be reduced by the coinsurance factor. In addition, the buyer-landlord will want a special endorsement added to the blanket policy reserving insurance proceeds provided by the blanket policy in an amount equal to the replacement cost of the sale and leaseback property.

From a practical viewpoint, the seller-tenant should see that a blanket or multiple location insurance policy, naming the buyer-landlord as an insured, limits the buyer-landlord’s insurable interest to casualties occurring to improvements on the sale and leaseback parcel only. If this is not done, the insurer will most likely issue a check in payment of any loss to any property covered by the blanket policy in the name of the buyer-landlord and the seller-tenant even though the buyer-landlord has no interest in the damaged property. The seller-tenant will then be required to procure the buyer-landlord’s endorsement on this check before using the insurance proceeds to restore the unrelated improvements. Limiting the buyer-landlord’s interest to the sale and leaseback parcel will avoid this practical problem.

Either the seller-tenant and the buyer-landlord or both should be named as insured in the casualty insurance policy or the seller-tenant should obtain an agreement in the lease exonerating itself from liability for the extent of insurance proceeds. Absent either of these two precautions, the insurer may well seek to recover from the seller-tenant for the seller-tenant’s negligence by way of subrogation to the rights of the buyer-landlord.

The buyer-landlord should be certain that all casualty insurance policies carried by the seller-tenant with respect to the improvements name the same insureds, cover the same property, protect against the same perils in the same amount, and otherwise contain concurrent terms. If, for example, the seller-tenant carried two fire insurance policies and the buyer-landlord was named in only one, the two companies would be co-insurers, and the buyer-landlord would not be able to recover the full amount of the proceeds.
Provisions differ with respect to the manner in which casualty insurance proceeds are to be allocated and paid out. Most commonly, insurance proceeds are paid to the buyer-landlord and made available to the seller-tenant as construction progresses. Any money in excess of the insurance proceeds required to complete the rebuilding must either be deposited with the buyer-landlord or first be paid by the seller-tenant to the parties restoring the improvements before the buyer-landlord disburses any insurance proceeds. This will help ensure that the improvements are restored and that the buyer-landlord will be afforded protection against mechanics lien claims by parties performing the restoration work or supplying materials for the work.

Often the buyer-landlord will agree, with regard to casualties below a certain fixed-dollar amount, that the seller-tenant will have a right to adjust the claims and collect proceeds. This avoids undue complications, burdens, and expenses in connection with relatively minor casualties. The credit standing of the seller-tenant is to be considered by the buyer-landlord before consenting to this provision.

As a practical matter, insurers often ignore the provision of the policy that the loss be payable directly to the buyer-landlord or to the seller-tenant and will make checks payable to all insureds (i.e., the buyer-landlord, the seller-tenant, and the mortgagee). In this event, the parties will have to endorse the checks over to the party entitled by the lease to hold the proceeds.

In some cases, especially when the seller-tenant has any question about the financial condition of the buyer-landlord, provision is made to pay the insurance proceeds to a trustee under a so-called insurance trust. The trustee is then directed to make disbursements under conditions similar to those in which the buyer-landlord holds the proceeds. The parties must remember, however, that corporate trustees must be compensated for their services and require exoneration from liability and protective provisions for assuming the duties of an insurance trustee.

Serious consideration should be given to requiring the seller-tenant to procure rent insurance in the buyer-landlord’s name or to procure rental value insurance in the seller-tenant’s name (or naming the seller-tenant and buyer-landlord as joint payees) to ensure the buyer-landlord a source of funds for the payment of rent during the period following any fire or other casualty. Availability of such a fund could become quite important for a buyer-landlord in the case of a seller-tenant without sufficient financial resources to pay rent during the restoration period. The seller-tenant will also benefit from the carrying of rent insurance even if not required by the lease since, as discussed in §5.39 below, the obligation to pay in a sale and leaseback situation does not abate because of damage or destruction to the improvements.

From a seller-tenant’s point of view, it is preferable to carry rental value insurance naming the seller-tenant as at least a coinsured. This avoids the possibility of a claim under a rent loss insurance policy by the insurer, who first pays the buyer-landlord the rent due and then, by subrogation to the buyer-landlord’s position under the lease, requires the seller-tenant to pay the rent to the insurer. This would result in the tenant’s paying for the rent loss insurance policy while still being required to make the rent payment.
The buyer-landlord may be best off with the rent loss insurance policy naming it as the insured. All proceeds will then be payable to the buyer-landlord. In a rental value insurance policy, the seller-tenant is the payee (or at least the copayee if the buyer-landlord is an additional insured), requiring the seller-tenant’s endorsement on all checks issued by the insurer.

3. [5.23] Relationship of Insurance Provisions to Lease Requirements of Mortgages and Subleases

If there is a mortgage on the fee, on the leasehold estate, or both, provision will also have to be made in the lease to permit the inclusion of appropriate mortgage clauses in the insurance policies and to govern the respective rights and priorities of the parties to the insurance proceeds. If a mortgagee seeks to require the use of insurance proceeds to reduce the mortgage debt, the money that would otherwise be available to pay the cost of repair or reconstruction will be depleted. If at all possible, the mortgage provisions on insurance proceeds should be conformed with the lease provisions to ensure the availability of insurance proceeds to pay for the restoration.

If the lease relates to property that is intended to be subleased, (e.g., a high-rise apartment building, an office building, or a shopping center), the subleases should be carefully drawn to correlate provisions regarding insurance and rebuilding with the provisions of the principal lease in order to avoid giving rights to subtenants in the insurance proceeds that conflict with the interests of the buyer-landlord, the seller-tenant, and the mortgagee in the insurance proceeds and their use.


In addition to the insurance provisions, the lease should contain broad indemnity provisions from the seller-tenant to the buyer-landlord for anything that happens in, on, or about the leased premises arising other than by reason of the buyer-landlord’s negligence or willful misconduct.

5. [5.25] Forms

The requirements for insurance are usually quite detailed, particularly with respect to fire and extended coverage and liability insurance. If the lease contains no detailed provisions, it should at least contain a very broad requirement for the seller-tenant to furnish such insurance as the buyer-landlord reasonably requires and as is customary in the locality for buildings and operations of the type involved. Sections 5.26 – 5.32 below contain some suggested sample forms.

a. [5.26] Provision Regarding Casualty Insurance and Rent Loss Insurance

Tenant covenants and agrees that it will at all times, at its sole cost and expense, keep the building or buildings and improvements on the Demised Premises insured against loss by fire with extended coverage if and when such insurance is available from an agency of the United States of America, for not less than [80 percent of its or their full insurable value above foundations, or any additional amount sufficient to prevent Landlord or Tenant from becoming a co-insurer within the terms of the applicable policies] [its or their full insurable value
above foundations] [its or their full replacement costs by a so-called "replacement cost" form policy in which the insurer will undertake to pay the full cost of repair or replacement of the damages or destroyed improvements and against such additional perils as Landlord may reasonably request], will procure rental insurance in any amount not less than one and one-half year’s Basic Rent insuring the rents from the Demised Premises, and will keep all such insurance in force and effect during the entire term of this Lease. Such insurance shall be procured from a responsible insurance company or companies reasonably satisfactory to Landlord and authorized to do business in the state in which the Demised Premises are located and shall provide for payment of loss [to Landlord] [as provided below]. The policies or certificates evidencing such insurance shall be delivered to Landlord upon the execution of this Lease, and renewals shall be delivered to Landlord at least [30] days prior to the expiration dates of the respective policies. Each such policy or certificate shall specifically provide that the policy may not be cancelled by the insurer without [10] days’ prior written notice to Landlord. The rental insurance to be provided under this Lease may, at Tenant’s option, be afforded by means of an endorsement placed on any policy of business interruption insurance carried by Tenant, insuring Landlord, as its interests may appear, with respect to any loss or damage under such policy that is attributable to the rental required to be paid by Tenant to Landlord under this Lease, which endorsement shall further provide that, in case the proceeds of insurance are insufficient to pay all loss or damage, the portion of the loss payable to Landlord by virtue of said endorsement shall first be paid.

b. [5.27] Provision for Payment of Casualty Insurance Proceeds to Tenant or Mortgagee

In the event of damage to any of the buildings and improvements situated on the Demised Premises from time to time by fire or other casualty, if Tenant is not in default under this Lease, and the net insurance proceeds payable as a result of such fire or other casualty equal not more than $______, such proceeds shall be paid to Tenant for restoration and rebuilding unless the loan documents evidencing and securing a leasehold mortgage permitted by this Lease or a mortgage on the fee require the insurance proceeds to be held by Mortgagee, in which case the insurance proceeds shall be paid to such Mortgagee to be disbursed by it to Tenant from time to time pursuant to the terms of this Lease to reimburse Tenant for the cost of repair, restoration, or rebuilding of the buildings and improvements, as Tenant incurs such costs.

c. [5.28] Provision for Payment of Casualty Insurance Proceeds to Insurance Trustee

At any time that _______ is not the landlord under this Lease, then, at Tenant’s election or at the election of a permitted mortgagee that is the holder of a leasehold mortgage on the leasehold estate under this Lease, insurance proceeds, in lieu of being paid to and held by Landlord as provided in this Lease, shall be paid to and held by a bank or trust company to be selected by and whose fees and charges shall be paid by Tenant, in trust, for the purposes and pursuant to the terms and provisions by which the proceeds would have been paid to and held by Landlord pursuant to this Lease. The bank or trust company shall have its principal office in the City of _______, State of _______, and shall have a capital and surplus of not less than [$15 million].
d. [5.29] Provision for Periodic Insurance Appraisal

Not less frequently than [once] in each [5] years after the commencement of the term of the Lease, Tenant shall furnish at its own expense to Landlord insurance appraisals such as are regularly and ordinarily made by insurance companies for such purpose in order to determine the then [insurable value] [replacement cost] of the buildings and improvements on the Demised Premises, above foundation. In addition, at the end of each [12]-month period following the last appraisal, the amount of each type of insurance coverage under the insurance policies provided by Tenant will be increased by the percentage increase in the [appropriate cost-of-living index] for such [12]-month period.

e. [5.30] Provision for Liability Coverage

Tenant covenants and agrees that it will at all times during the term of this Lease carry and maintain, for the mutual benefit of Landlord and of Tenant, general public liability insurance against claims for personal injury, death, or property damages occurring in, on, or about the Demised Premises or buildings and improvements situated on the Demised Premises or in, on, or about the streets, sidewalks, or premises adjacent to the Demised Premises, under policies in form and companies approved by Landlord, such insurance to afford protection to the limit of not less than $________ in respect to injury to or death of a single person, to the limit of not less than $________ in respect to any one accident, and to the limit of not less than $________ in respect to property damage, and will also carry to the mutual benefit of Landlord and of Tenant steam boiler insurance (casualty and liability coverage) on all steam boilers, pressure boilers, and other apparatus, if any, and escalator and elevator liability insurance on all escalators or passenger or freight elevators (if any) that may be in and on the Demised Premises or the buildings and improvements situated on the Demised Premises, in an amount, in form, and with companies reasonably satisfactory to Landlord. On the expiration date of each such policy, any replacement policy shall afford protection minimum limits increased from the minimum limits then in effect under this Lease by multiplying the then-current minimum limits by a fraction, the numerator of which shall be the [appropriate cost-of-living index] on the first day of the last month of the expiring policy term and the denominator of which shall be such index on the first day of the first full month of the expiring policy term, except that in no instance shall the amount of the minimum limits be decreased. Tenant shall also carry a policy insuring against liability under the statutes of the state in which the Demised Premises are located relating to the sale or dispensation of alcoholic liquors, naming Landlord and any mortgagee of the fee or leasehold as insureds, in the same limits as provided in the following part of this document with respect to general public liability insurance. Tenant shall furnish landlord with a duplicate certificate or certificates of the insurance policy or policies that state the number of each such policy, the name of each insurer, the amount of insurance under each such policy, and the date of expiration of each such policy, and containing the insurer’s agreement not to cancel or terminate any such insurance coverage without giving Landlord not less than [10] days’ prior written notice. Tenant further agrees that it shall from time to time, whenever required, satisfy Landlord that such policy or policies is or are in full force and effect.
f. [5.31] General Insurance Provision

Tenant will also maintain at its expense such other insurance in such amounts as are or shall be customarily carried and insuring against such insurable hazards as are or shall be customarily covered with respect to buildings similar in construction, general location, use, and occupancy to the buildings from time to time on the Demised Premises, as and when insurance against such insurable hazards is obtainable.

g. [5.32] General Indemnity Provision

Tenant covenants and agrees with Landlord that Tenant will indemnify and keep Landlord harmless at all times against any loss, damage, cost, or expense (including, but not limited to, attorneys’ fees and expenses) incurred by Landlord and will defend Landlord in all proceedings (unless Landlord elects to assume its own defense as hereinafter provided), arising by reason of or growing out of (1) Tenant’s failure in any way to maintain the Demised Premises and the buildings and improvements situated on the Demised Premises as required by this Lease; (2) any accident, loss, or damage resulting to persons or property from any use that may be made of the Demised Premises and the buildings and improvements situated on the Demised Premises; (3) any act or thing done or omitted to be done or any occurrence on the Demised Premises and the buildings and improvements situated on the Demised Premises; and (4) any damage that may be sustained by adjoining property or adjoining owners or other persons or property in connection with any remodeling, altering, or repairing of any building or buildings on the Demised Premises or the erection of any new building or buildings on the Demised Premises. Tenant further covenants and agrees that in case Landlord shall, without fault on its part, be made a party to any litigation involving the Demised Premises or buildings and improvements situated on the Demised Premises and Landlord elects to assume its own defense, then Tenant shall and will pay all costs and expenses, including all attorneys’ fees and expenses, incurred by or imposed on Landlord by or in connection with such litigation. Landlord’s election to assume its own defense in any such litigation shall in no way limit Tenant’s indemnification obligations contained in the first sentence of this paragraph. Tenant finally covenants and agrees to pay all costs and expenses, including attorneys’ fees and costs, that may be incurred by Landlord in enforcing any of the covenants and agreements under this Lease. Any such costs and expenses that tenant has agreed to pay in this paragraph shall be so much Additional Rental due on the next rent date after such payment or payments, together with interest at the rate of 5 percent per annum from the date of payment of costs and expenses by Landlord until repayment of costs and expenses by Tenant to Landlord.

F. Rebuilding and Termination

1. [5.33] General Requirements

The seller-tenant is almost always required to rebuild following damage to or destruction of the improvements on the demised premises with the right to use insurance proceeds for this purpose. The lease must clearly impose this obligation to rebuild on the seller-tenant since, at common law, the seller-tenant is under no obligation to rebuild or restore after a fire or other casualty. Lewis v. Real Estate Corp., 6 Ill.App.2d 240, 127 N.E.2d 272 (1st Dist. 1955).
Generally, the seller-tenant’s obligation of repair or replacement will be stated in terms of valuation, i.e., that after restoration the improvements shall have the same value, rental and otherwise, as immediately prior to the damage or destruction. In some cases, particularly if the improvements are unique, the seller-tenant may be required to restore them substantially to their former state.

If the proceeds of insurance are not sufficient to permit the seller-tenant to repair or restore in accordance with the lease, the seller-tenant is usually required to supply the necessary excess funds. By the same token, if the insurance proceeds exceed the costs of restoration, the seller-tenant usually is entitled to retain them if not in default.

A buyer-landlord may be willing to give the seller-tenant an election not to rebuild or restore if the damage or destruction to the improvements occurs near the end of the term of the lease or of a renewal term (usually during the last two or three years) and exceeds a stated amount (for example, 50 percent or more of insurable value) or constitutes damage that cannot be restored in a fixed period of time (for example, within 90 days). If the seller-tenant is excused from rebuilding, the lease terminates, and proceeds of insurance paid by reason of the destruction of the buildings and improvements are usually paid to and retained by the buyer-landlord; insurance proceeds paid for the seller-tenant’s trade fixtures and other personal property are paid to and retained by the seller-tenant.

A seller-tenant with some bargaining power might be able to negotiate an arrangement by which, upon an early termination of the lease following total destruction of the improvements by fire or other casualty, the buyer-landlord will receive a distribution in the form of the seller-tenant’s interest in the property and insurance proceeds equal to the sum of the present value of the buyer-landlord’s lost income stream from the rentals during the balance of the lease term plus the present value of the reversion to which the buyer-landlord would have been entitled at the end of the lease term. Any insurance proceeds remaining after this distribution to the buyer-landlord will be paid to the seller-tenant. This form, similar in many ways to the allocation of condemnation proceeds, will place the buyer-landlord in the same position as it would have been placed had the lease run its full course and will prevent the buyer-landlord from realizing a windfall by reason of the early termination of the lease.

See §5.39 below for a discussion of seller-tenant’s obligation to pay rent during the period of repair or restoration.

2. Forms

a. [5.34] Provision for Tenant To Restore in Case of Damage or Destruction

In the event of destruction of or damage to the buildings and improvements on the Demised Premises by fire or other casualty, Tenant shall promptly at its own expense repair, restore, or rebuild them so that, upon the completion of repairs, restoration, or rebuilding, the value and rental value of the buildings and improvements shall be substantially equal to the value and rental value of the buildings and improvements immediately prior to the fire or other casualty.
Unless this Lease is terminated following the fire or other casualty as provided below, the insurance proceeds payable by reason of such damage or destruction shall be paid to and held by Landlord, to be paid by Landlord to Tenant upon receipt of architects’ certificates, contractors’ and subcontractors’ sworn statements, and waivers of lien to reimburse Tenant for the expense of repairing or rebuilding the buildings and improvements that have been damaged or destroyed; provided, however, that it shall first appear to the satisfaction of Landlord that the amount of insurance money in its hands, together with any additional funds deposited with Landlord or expended by Tenant, shall at all times be sufficient to pay for the completion of said repairs or rebuilding, free and clear of liens and claims for lien. Upon the completion of the repairs or rebuilding, free from all liens of mechanics and material suppliers and others, any surplus of insurance money shall be paid to Tenant, provided Tenant is not in default under any of the provisions of this Lease, in which event of Tenant’s default Landlord may apply the surplus against the default. If this Lease is terminated by reason of any default by Tenant, all insurance proceeds in the hands of Landlord and all claims against insurers shall become the absolute property of Landlord. If the insurance proceeds shall be insufficient to cover the cost of repairs and restoration of the buildings and improvements, the deficiency shall be paid by Tenant. In the event of loss covered by rental insurance, the proceeds received by Landlord shall be credited against the Basic Rent.

b. [5.35] Provision Allowing Termination of Lease Following Destruction by Fire or Other Casualty

If, within ____ years prior to the expiration of the initial term of this Lease (unless the initial term of this Lease has been renewed) or, if the initial lease term has been renewed, at any time within ____ years prior to the expiration of the last exercised renewal term, the buildings and improvements shall be destroyed or damaged by fire or other casualty [to render at least ____ percent of the net rentable area untenable] [to the extent of at least ____ percent or more of the then full insurable value] and provided that at the time of the destruction or damage all insurance required to be maintained pursuant to this Lease shall then be in full force and effect and Tenant shall not be in default under this Lease, Tenant shall have the option of restoring, repairing, replacing, rebuilding, or altering the buildings and improvements as stated above or of terminating this Lease by giving written notice of the election to Landlord within [90] days after the destruction or damage, the notice to specify a date, not less than [10] days from the date of delivery of the notice to Landlord, on which Tenant elects to terminate this Lease. If the Lease is terminated, Tenant shall not be required to restore, repair, replace, rebuild, or alter the building or to pay the cost of those remedies, and all proceeds of insurance paid by reason of the destruction of the buildings and improvements shall be retained by Landlord as and for its own absolute property. Tenant shall be entitled, in this case, to the proceeds of insurance paid by reason of the destruction of Tenant’s trade fixtures and personal property. Tenant’s rights to terminate this Lease, as provided above, shall be subject to the condition that Tenant pays the Basic Rent, Additional Rental, and all other charges payable by Tenant under this Lease up to the date specified in the notice of termination given by Tenant to Landlord as provided above simultaneously with the giving of notice.
G. Condemnation

1. [5.36] In General

In Illinois, in the absence of a lease provision to the contrary, tenants under long-term ground leases are not entitled to an abatement of rent following a partial condemnation. The law is well established [however] that lessees for years holding under a valid lease have such an interest in real property as to be classified as owners in the constitutional sense and are entitled to compensation for the taking of their interest in the property. *Department of Public Works & Buildings v. Metropolitan Life Insurance Co.*, 42 Ill.App.2d 378, 192 N.E.2d 607, 610 (1st Dist. 1963).

In a total taking, the court explained in *Metropolitan Life* the condemnation award is divided as follows (assuming the absence of a specific condemnation provision in the lease to the contrary):

The tenant’s liability for rent having necessarily ceased, the landlord’s share of the award was set as the sum of: (a) The present value of the rents reserved, and (b) The present value of the reversionary interests. The tenant was to receive ... [t]he value of the leasehold, subject to the rents covenanted to be paid. 192 N.E.2d at 611.

In a partial taking, the court in *Metropolitan Life* endorsed two alternative formulae that could be employed to compute the landlord’s and tenant’s shares of the partial condemnation award, again assuming no specific lease provision to the contrary. Under the first formula, “the landlord is entitled to (1) the present value of rents reserved, except where rent is not abated or terminated, and (2) the present value of his reversionary interest [in the portion of the property taken], except in long-term lease situations.” 192 N.E.2d at 612. The exception is made for the present value of the landlord’s reversionary interest in long-term lease situations because, as the court stated, “Illinois courts have consistently held that a reversion after a long-term lease has no market value.” 192 N.E.2d at 611 – 612.

Under the second formula endorsed by the court — the “bonus value” formula — the court, in a reversal of the first formula, first determines the tenant’s interest in the partial taking award and then allocates the residue to the landlord. In this case, the present value of the rentals to be paid for the taken portion of the property over the balance of the lease term is deducted from the present value of the lost portion of leasehold, and this amount is paid to the tenant; the balance is paid to the landlord. 192 N.E.2d at 612 – 613. In *Metropolitan Life*, the application of either formula resulted in a de minimis distribution to the landlord, so the court allocated the entire partial taking award to the tenant. See also *Department of Public Works & Buildings v. Blackberry Union Cemetery*, 32 Ill.App.3d 62, 335 N.E.2d 577 (2d Dist. 1975), in which the court followed the “partial taking” test set forth in *Metropolitan Life*.

It should be noted that inherent in the two alternative formulae for the allocation of a partial condemnation award is the concept that the tenant continues to be obligated to pay rent on the lost
portion of the leasehold. If the tenant is relieved from paying rent on the lost portion of the leasehold, the formula to be applied would most likely be a variation of the formula for a total taking, as set forth above.

In Metropolitan Life, the court also considered, as an element of the tenant's damages, the fact that the tenant had negotiated a ground lease rental in an amount substantially under the current market rental for property comparable to the taken property. Accordingly, the court also awarded the tenant an amount representing a loss of its special bargain. 192 N.E.2d at 613. This most likely would apply only in a bargain-rent situation.

In a long-term ground lease, if the tenant has the right, on the expiration of the term, to remove fixtures, structures, or other improvements installed by the tenant on the property, the tenant is also entitled to be compensated for the taking of these fixtures, structures, or other improvements. Whether the tenant has a right to compensation for the taking of these items will often resolve who is entitled to receive the award made by reason of the taking of these items. Empire Building Corp. v. Orput & Associates, Inc., 32 Ill.App.3d 839, 336 N.E.2d 82 (2d Dist. 1975).

Great difficulties are encountered in drafting and negotiating condemnation provisions despite the remoteness of the contingency involved. As the caselaw discussed above indicates, such condemnation provisions can have substantial and far-reaching effects should a total or partial condemnation occur during the usually long term of the lease. In addition, care must be taken to coordinate the condemnation provisions of the lease with corresponding provisions of any mortgage affecting the property.

There are infinite varieties of condemnation provisions, rendering it difficult to select specific provisions as being "typical." The most that can be done in this limited discussion is to mention a few types of provisions. Regardless of which alternative is used, the parties should avoid adopting a solution that would make the transaction appear as though it were a masked mortgage loan secured by an equitable mortgage (i.e., stating that the rent payments would be reduced because of a return of part of the landlord's investment as opposed to a rental reduction reflecting the rental value of the diminished premises). See §5.11 above.

2. General Description of Some Types of Condemnation Provisions in Use in Sale and Leaseback Transactions

a. [5.37] Total Taking

The lease may require the seller-tenant to waive all rights to the award or all rights with respect to its leasehold estate (reserving only rights for leasehold improvements paid for by the seller-tenant). The lease may award the buyer-landlord damages for the land and provide for the buyer-landlord and the seller-tenant to share the award with respect to the improvements in accordance with their respective interests therein or provide for separate awards to the buyer-landlord and the seller-tenant as their interests may appear.
While providing generally for separate awards, the lease may require that the buyer-landlord receive a stated minimum out of the award before the seller-tenant can participate in the award. This minimum award may be set forth either in the form of a fixed-dollar figure or of a formula to give the buyer-landlord the equivalent of the unamortized portion of the buyer-landlord’s investment or to give the buyer-landlord the present value of the lost income stream and the present value of the reversionary interest in the property. (In some cases, there is an additional requirement that if the total award is not sufficient to make the buyer-landlord whole, the seller-tenant must pay the deficiency even though the seller-tenant will receive no portion of the award; the disadvantage of this approach, however, is that it lends the appearance of a loan instead of a lease to the transaction.)

The lease may obligate the seller-tenant to purchase the premises from the buyer-landlord at an agreed price (or with the purchase price based on an agreed formula) so that the seller-tenant will be entitled to the entire award upon payment of the purchase price of the buyer-landlord.

b. [5.38] Partial Taking

The seller-tenant may have an election to terminate the lease if the taking exceeds a certain percentage, affects certain portions of the property vital for the seller-tenant’s effective use of the property, or otherwise renders the property unfit for its stated use. The buyer-landlord may have a similar option, either with or without that option being afforded to the seller-tenant. In either of these situations, if the lease terminates, the provisions for total taking will then apply. If the lease does not terminate, the seller-tenant is obligated to restore any improvements that are physically damaged with the right to use the proceeds of the award for this purpose. Either this right can be limited to the proceeds specifically awarded to the seller-tenant, or the award can be treated as a lump sum for this purpose, with any surplus going to the buyer-landlord. In any case, provision must also be made for the seller-tenant to pay any deficiency using the seller-tenant’s funds before using the award. Disbursement of these funds to pay for rebuilding will follow the mechanics for disbursements of insurance proceeds following destruction by fire or other casualty.

After the award is used for rebuilding or after any other distribution provided for, appropriate provision must be made as to whether there is to be an adjustment of rent. In some cases, the seller-tenant continues to remain liable for the full amount of rent despite the buyer-landlord’s receipt of a portion of the award; in this case, the allocation formulae set forth in Department of Public Works & Buildings v. Metropolitan Life Insurance Co., 42 Ill.App.2d 378, 192 N.E.2d 607 (1st Dist. 1963), would apply in the absence of a contrary lease provision.

Rent can be adjusted on the basis of percentage of area taken or of the relative value of the land remaining (determined by the court or perhaps by appraisal) as compared to the value of the whole before taking.

Rent can also be adjusted by treating the buyer-landlord’s share of the award (or the portion remaining after rebuilding if any of the buyer-landlord’s share is used for that purpose) as a repayment of the buyer-landlord’s original investment and by reducing the rent to produce the
same rate of yield or the same rate of amortization applied to the reduced amount of the buyer-
landlord's investment. Note, however, that this type of adjustment would support a
recharacterization agreement by the seller-tenant that the lease is, in fact, a mortgage security or
loan.

The rent may be reduced in a manner that is equitable, leaving it to a court or to arbitrators to
decide what is "equitable."

H. [5.39] Non-Abatement of Rent

In another type of lease, rental never abates by reason of damage or destruction to the
improvements by fire or other casualty unless the seller-tenant has an election to terminate the
lease, as mentioned in §5.33 above, and exercises this option or unless the lease provides
otherwise. This principle is well established under Illinois law if the tenant has a leasehold
interest in land as well as improvements. In Humiston, Keeling & Co. v. Wheeler, 175 Ill. 514, 51
N.E. 893 (1898), the court stated that if the tenant has leased both the land and the improvements,
rent must be paid after total destruction of the buildings by fire or other casualty since the lease
was of the land and building and there remained something to which the lease attached even if the
building was destroyed. See also Lewis v. Real Estate Corp., 6 Ill.App.2d 240, 127 N.E.2d 272
(1st Dist. 1955). Similarly, a taking by condemnation or eminent domain that does not result in a
taking of the entire demised premises does not result in an abatement of rent unless the lease
provides otherwise. Department of Public Works & Buildings v. Metropolitan Life Insurance Co.,
42 Ill.App.2d 378, 192 N.E.2d 607 (1st Dist. 1963); Great Atlantic & Pacific Tea Co. v. State of
Ill.App. 500 (1st Dist. 1888); Nonotuck Silk Co. v. Shay, 37 Ill.App. 542 (1st Dist. 1890). This
rationale is even more compelling in the type of sale and leaseback situation in which the seller-
tenant has leased the land only and holds title to the buildings during the term of the lease.

The seller-tenant can protect itself from loss in the case of destruction of the improvements
by means of rent loss insurance or rental value insurance. Provision is often made in leases
requiring the seller-tenant to carry this type of insurance. See §5.22 above.

See §5.17 above for a sample provision expressing the concept of non-abatement of rent and
§5.26 above for a sample provision requiring the seller-tenant to carry rental insurance.

I. Fixtures and Improvements

1. [5.40] Fixtures

The lease should include a provision governing the rights of the buyer-landlord and the seller-
tenant with regard to fixtures installed in the improvements. In one of the basic types of sale and
leaseback transactions, if the seller-tenant has sold the buyer-landlord all of the improvements,
the buyer-landlord will also succeed to title to all fixtures located in the improvements. There
may be instances, however, even in this basic type of transaction, in which the seller-tenant
retains title to certain fixtures. The retained fixtures may constitute the seller-tenant's trade
fixtures or even building fixtures that the parties may have agreed have not been included in the
agreed dollar amount of the purchase price, even though the buyer-landlord has acquired title to
the improvements. Appropriate provisions in this regard should be incorporated in the deed from
the seller-tenant to the buyer-landlord and in the lease since, in the absence of agreement between
the parties, the tenant has a statutory right to remove all removable fixtures erected on the
property by it during the term of the lease while it remains in possession as tenant. 735 ILCS 5/9-
319.

In the second basic type of transaction, if the buyer-landlord purchases the land only, the
seller-tenant retains title to and the right to depreciate the fixtures. In this instance also, the lease
should clearly spell out which fixtures, if any, the seller-tenant may remove prior to the end of the
lease term and which fixtures pass to the buyer-landlord after the end of the lease term.

Agreement as to the seller-tenant’s right to remove fixtures (including buildings, as discussed
in §5.41 below) can be of particular importance with regard to the allocation of an award
resulting from a condemnation of the property. In Empire Building Corp. v. Orput & Associates,
Inc., 32 Ill.App.3d 839, 336 N.E.2d 82 (2d Dist. 1975), involving a dispute between the landlord
and tenant over the allocation of a condemnation award, the court held that since the tenant had
the right, prior to expiration of the lease term, to remove fixtures, structures, and other
improvements installed and erected by him on the property, he was entitled to be compensated for
such improvements from the condemnation award. The seller-tenant’s right to remove buildings
or fixtures was material in the apportioning of the condemnation award between the buyer-
landlord and seller-tenant. See §5.36 above.

2. Improvements

a. [5.41] Vesting of Title to Improvements

In the type of sale and leaseback transaction in which the buyer-landlord acquires both the
land and improvements, title to the improvements immediately vests in the buyer-landlord,
subject only to the seller-tenant’s leasehold estate. At the end of the lease term, the seller-tenant’s
lease rights terminate, and the buyer-landlord succeeds to unencumbered title to the
improvements.

More complicated questions are presented, however, in the type of transaction in which the
buyer-landlord acquires the land only, while the seller-tenant retains title to present or future
improvements during the lease term. Many leases used in this type of sale and leaseback
transaction provide that the seller-tenant retains ownership of the improvements during the lease
term but that the buyer-landlord automatically becomes the owner of the improvements upon
termination or expiration of the lease. These concepts pose the following problems for the buyer-
landlord and the seller-tenant that the drafter must carefully analyze in view of the particular set
of circumstances in order to provide adequate safeguards of each party’s interest:

1. The buyer-landlord has purchased and owns the land and residual interest in the
improvements. The buyer-landlord’s funds have been used almost exclusively to purchase the
land since the reversionary interest in the improvements at the end of a long-term lease is almost
valueless at the time of purchase. The rent is, therefore, based principally on a return of the buyer-
landlord’s investment in the land. However, the buyer-landlord has purchased the land and made the lease in anticipation of receiving the benefit of ownership of the improvements when the lease expires. The buyer-landlord consequently must be assured that, upon termination of the lease, clear title to the improvements will be vested in it.

2. The seller-tenant, on the other hand, has invested its money in the improvements and should be afforded all the rights of ownership of them while the lease is in effect, including the right to take depreciation on the improvements for tax purposes.

Leases used in land-only sale-leasebacks often provide that any improvements owned by the seller-tenant remain the seller-tenant’s property during the lease term but that, upon termination of the lease, title to the improvements automatically vests in the buyer-landlord. Courts have enforced these so-called “automatic vesting” provisions. In Royal Neighbors of America v. Bank of Commonwealth, No. 77-1226 (E.D.Mich. Dec. 27, 1976), aff’d in an unpublished opinion, 595 F.2d 1225 (6th Cir. 1979), in which a landlord brought suit to quiet title to the improvements in itself upon termination of the lease by default, the court was required to interpret a lease provision that provided:

[U]pon termination of the leasehold estate hereunder, either by lapse of time on November 30, 1998, or otherwise prior thereto, the Building shall thereupon, without any act by either party, be and become the absolute property of the Lessor, who shall thereupon be and become the owner of the Building, free and clear of all rights or claims of Lessee.

The court granted the landlord’s motion for summary judgment and held that the landlord automatically became the fee owner of the improvements upon termination of the lease. In Uvesco, Inc. v. Petersen, 295 So.2d 353, 354 (Fla.App. 1974), the court was faced with a lease provision that provided, upon default, that the tenant’s interest would terminate and the title to and ownership of all buildings would automatically vest in the landlord. The court rejected the tenant’s contention that the landlord could terminate the lease and obtain clear title to the improvements only through foreclosure proceedings and held that, in accordance with the lease, the landlord could terminate the lease upon tenant’s default and obtain title to the improvements. Id. Finally, in In re Kassuba, 562 F.2d 511, 513 – 514 (7th Cir. 1977), the court enforced an automatic vesting provision in a lease that provided, upon termination of the lease either at the end of the term or upon default, that ownership of the improvements would vest in the landlord even though the tenant defaulted early in the lease term and thus forfeited most of the improvements’ value.

Different considerations prevail in “automatic vesting” clauses, depending on whether the improvements in question predated or postdated the beginning of the land lease. The general rules regarding the title to improvements constructed by the tenant on the leasehold after the beginning of the lease term are well summarized in Chicago Title & Trust Co. v. Fox Theatres Corp., 164 F.Supp. 665 (S.D.N.Y. 1958), as follows: (1) in the absence of an agreement to the contrary, title and ownership of structures erected by one party on the land of another is in the landowner; (2) buildings erected by the tenant for trade purposes will be deemed trade fixtures that, in the absence of a provision to the contrary, are the tenant’s property and removable by it during the
term of the lease or within a reasonable time thereafter; and (3) if the lease between the parties covers the disposition of the improvements, the court will give effect to the intent of the parties as expressed in the lease. The court held that under the terms of the lease in question, the parties intended that the buildings erected by the tenant would be the property of the landlord at the end of the lease term and that the tenant had no right to remove them or to force a sale of land and improvements and a division of the proceeds.

Automatic vesting provisions, when the tenant constructs the improvements after the lease has been entered into, can be upheld on a number of theories. At common law, title to any improvements constructed by the tenant on the landlord's property vest immediately in the landlord, giving the landlord a present interest in the improvements as soon as they are constructed. Id. By the terms of the lease in a sale-leaseback transaction in which title to the improvements is retained by the seller-tenant, the parties delay the passage of title to the improvements and, therefore, create, at the very least, a future interest in the improvements in the buyer-landlord. An argument can be made, however, that the buyer-landlord has a present interest in the improvements (which can be insured by a title insurer at the inception of the transaction) instead of merely a future interest. If, by common law, title to the improvements automatically vests in the landlord, then arguably the ground lease reserving title to the improvements merely creates an estate for years in the improvements in the tenant with the reversion in the landlord creating a present (and insurable) interest.

Another theory supporting the automatic vesting of title can be derived from the judicial treatment of fixtures and improvements the tenant has installed on a leasehold estate and that the tenant has a right under the lease to remove. The courts have recognized that a tenant may be granted the right in the lease to remove improvements from the leased premises, meaning that the fixtures are the tenant's property. Id. This right lapses, however, if not exercised by the end of the lease term, with the title thereafter automatically vesting in the landlord. For example, in Fitzgerald v. Anderson, 81 Wis. 341, 51 N.W. 554 (1892), the court stated that while a tenant under a lease may have the right to remove improvements constructed by it, such removal right must be exercised by the tenant while it is still rightfully in possession under the lease or the right will be lost. The landlord will then succeed to title to the improvements. In Dreiske v. People's Lumber Co., 107 Ill.App. 285 (1st Dist. 1903), the court treated buildings as removable trade fixtures but held that since the tenant failed to remove them before expiration of the lease, he could not claim ownership of them against the owner of the land. See also Young v. Consolidated Implement Co., 23 Utah 586, 65 P. 720 (1901).

From this concept, it is just a short step to the ownership of the buildings and improvements by the seller-tenant during the lease term and the automatic vesting of title in the buyer-landlord when the lease term ends. Under this theory, however, it is more difficult to find a present interest of the buyer-landlord in the improvements that is insurable by title insurance at the inception of the sale-leaseback transaction and will withstand a challenge that the automatic vesting provision may be a future interest, unenforceable as a violation of the rule against perpetuities.

While the foregoing might justify automatic vesting in cases in which improvements postdate the lease, more difficult theoretical problems are presented when the improvements are in existence at the time of the sale-leaseback. The buyer-landlord, who never received an interest in
the improvements by a conveyance, cannot rely on the cases described above to obtain a present or future reversionary interest in the improvements by operation of law. The improvements were not constructed on land in which the buyer-landlord held a reversionary interest at the time of construction. Furthermore, as noted above, a provision in the lease that provides that title to the improvements will vest in the buyer-landlord at the end of the lease term may be a future interest, unenforceable as a violation of the rule against perpetuities. Nevertheless, as noted above, in Royal Neighbors, supra, in which the improvements predated the sale-leasebacks, the court enforced the automatic vesting provision contained in the ground lease and held that the buyer-landlord became the owner of the improvements upon the termination of the lease. Although the court could not pigeonhole the type of estate the lease provision created, it found (1) that there was a clear agreement between the parties to convey the improvements to the buyer-landlord, and (2) that during the term of the lease the buyer-landlord was in the position of a vendee under an executory land contract and had a vendee’s equitable interest in the building. Thus, the court reasoned, the automatic vesting provision could be enforced.

Even if an automatic vesting lease provision is held not to create an enforceable legal or equitable interest in the buyer-landlord in the improvements (whether existing or to be constructed), two theories might be used by a court to conclude that title to the improvements automatically vested in the buyer-landlord at the end of the lease term. First, the lease provision calling for title to pass to the buyer-landlord at the end of the lease term may be specifically enforceable in the same manner as any contract calling for a conveyance of real property. For example, in Kassuba, supra, in which the improvements predated the sale and lease, the court simply enforced the lease provision for the automatic vesting of title to improvements upon termination of the lease in the same manner as a court would enforce any contractual provision. In so doing, the court took comfort in enforcing the intent of the parties from the fact that the seller-tenant, when agreeing to the automatic vesting provision, was “sophisticated in matters of real estate financing.” 562 F.2d at 515. Another rationale courts may use to find that title to improvements automatically vests in the landlord is that if the seller-tenant improvements remain on the buyer-landlord’s property after the termination of the lease, the improvements may be deemed abandoned property and, as such, pass to the buyer-landlord by operation of law. Tkach v. American Sportsman, Inc., 316 N.W.2d 785 (N.D. 1982); Lilienquist v. Pitchford’s, Inc., 269 Or. 339, 525 P.2d 93 (1974). See also 2 Milton R. Friedman, FRIEDMAN ON LEASES §22-8, p. 22-33 (5th Randolph rev. ed. 2007).

Even though automatic vesting provisions by virtue of provisions in leases have received judicial endorsement, doubts still prevail as to the rights of the buyer-landlord to receive good title to the improvements at the end of the lease term simply by virtue of automatic vesting provisions. Many title insurers refuse to insure the buyer-landlord’s interest in the improvements when only automatic vesting provisions are used, especially in cases in which the improvements predate the sale and lease. These title insurers fear that the lack of a specific conveyance of the improvements or the failure to create a present estate in the improvements may cloud the buyer-landlord’s title to the improvements. To overcome these doubts, the following suggestions should be considered:

1. The buyer-landlord could, by a lease provision, require the seller-tenant, at the buyer-landlord’s request upon termination of the lease, to execute, acknowledge, and deliver a quitclaim
deed and bill of sale conveying the improvements to the buyer-landlord. Brian J. Strum, Sale-Leasebacks: Protection for Accelerated Depreciation Deduction and Clear Title, 7 Real Prop.Prob. & Tr.J. 785, 786 (1972) (Strum). This approach is unsatisfactory, however. A seller-tenant in default is unlikely to voluntarily execute a deed to the improvements. The buyer-landlord would therefore be required to litigate its rights to the improvements by an action in the nature of specific performance, depriving the buyer-landlord of the right to speedy possession of title to the improvements. This alternative offers little (if any) advantage over the automatic vesting provisions discussed above. It also offers no inducement to a title insurer to insure, at the inception of the sale-leaseback transaction, the buyer-landlord’s rights in the improvements upon termination of the lease.

2. A similar approach would be to require the seller-tenant, at the time the sale-leaseback of the land is closed, to appoint the buyer-landlord as its attorney-in-fact with power to execute, acknowledge, and deliver a deed and bill of sale upon termination of the lease. This approach, however, has deficiencies if the buyer-landlord attempts to terminate the lease by reason of the seller-tenant’s default. Even though the buyer-landlord could execute and record the deed following the seller-tenant’s default, the seller-tenant could contest the validity of the deed and the buyer-landlord’s title to the improvements on the grounds that the buyer-landlord had no basis for terminating the lease and thus no power to execute the deed. The buyer-landlord may well be forced to bring an action to quiet title. Again, this alternative will not induce a title insurer to insure the buyer-landlord’s interest in the improvements at the inception of the sale-leaseback transaction.

3. The seller-tenant could place a deed to the improvements into an escrow when the sale-leaseback of the land is closed, subject to escrow instructions that provide that the deed is to be recorded at the end of the lease term or on the occurrence of an event of default that allows the buyer-landlord to terminate the ground lease. Two problems must be considered if this structure is adopted. First, the seller-tenant may deny that a default has occurred that would justify the lease termination and recording of the deed. In such a case, the seller-tenant’s demand on the escrowee or, if necessary, the seller-tenant’s initiating legal proceedings for a court order preventing recording of the deed may well dissuade the escrow agent from recording the deed. This in turn will force the buyer-landlord to litigate its right to the improvements. As a result, the buyer-landlord will be denied the remedy of obtaining speedy title to the improvements upon a seller-tenant’s default — a major inducement for using the sale-leaseback structure over a mortgage in which foreclosure is required to obtain title to the improvements. Again, there is no inducement to a title insurer to give the desired insurance.

Second, placing the deed to the improvements into an escrow subject to certain limitations that the seller-tenant may well insist on may not constitute proper delivery of the deed. To have an effective delivery of a deed to an escrow agent (thus allowing a title insurer to give the required insurance at the inception of the sale-leaseback transaction), the grantor must abandon both possession and control of the deed so that the grantor no longer retains any right to recall the deed or control its use in the future. See, e.g., Johnson v. Johnson, 24 R.I. 571, 54 A. 378 (1903). By placing the deed to the improvements into escrow in a manner that would constitute effective delivery of the deed (the seller-tenant having abandoned possession with no right to recall the deed or to direct the escrow agent to change the use of the deed in the future), a seller-tenant may
have surrendered rights to contest the validity of the deed in the event the buyer-landlord contends that it is entitled to the deed by reason of a default and early termination of the lease. A solution — conditioning delivery of the deed from escrow on a judicial determination of default and proper lease termination — may well be acceptable to the seller-tenant but not to the buyer-landlord and the title insurer. Such a solution deprives the buyer-landlord of the ability to gain title to the improvements upon default without litigating the matter.

4. The parties could structure the transaction using an estate for years, especially in the more troublesome situation in which the improvements predate the sale and leaseback. If the improvements are in existence at the time of the sale-leaseback, the seller-tenant could, at the date of sale, convey title to the improvements to the buyer-landlord subject to the reservation of an estate for years in the seller-tenant, coextensive in duration with the term of the lease of the land. Both the deed and the ground lease would provide that the estate for years would be cut short if the seller-tenant defaulted under the ground lease. Since the buyer-landlord obtains a present interest in the improvements, the estate for years structure avoids any potential future interest problem or any question concerning the type of estate created in the buyer-landlord. As noted in *Royal Neighbors, supra*, the court held that the buyer-landlord did not have a legal estate in the improvements because it did not have a present interest in the improvements. By using the estate for years structure, the buyer-landlord would clearly have a present legal estate in the improvements and would not have to rely on a court’s finding, as in *Royal Neighbors*, that the buyer-landlord had an equitable interest in the property.

This current interest of the buyer-landlord in the improvements, subject to the seller-tenant’s estate for years, should be as insurable by a title insurer as the buyer-landlord’s interest in the land is subject to tenant’s leasehold estate. The estate for years concept should be acceptable to the seller-tenant also, since the seller-tenant has not given up its right to contest the early termination of this interest in the improvements, should the seller-tenant dispute a lease default alleged by the buyer-landlord.

Arguably, the estate for years structure may also be used when the seller-tenant is to construct the improvements after the sale and leaseback has been consummated, if the seller-tenant conveys by warranty deed any after-acquired improvements to the buyer-landlord, subject to an estate for years reserved to the seller-tenant.

At common law, a deed conveying property in the nature of an expectancy is void. See, *e.g.*, *Harper v. Harper*, 241 Ga. 19, 243 S.E.2d 74 (1978); *Trammell v. West*, 224 Ga. 365, 162 S.E.2d 353 (1968). However, some courts, applying equitable principles, have held that a grantor of a warranty deed conveying property the grantor does not own but to which it subsequently acquires title is estopped from denying the validity of the deed with respect to the grantee named in the deed. See, *e.g.*, *Pure Oil Co. v. Miller-McFarland Drilling Co.*, 376 Ill. 486, 34 N.E.2d 854 (1941). Although a buyer-landlord relying on this equitable theory might be able to assert a present interest in the improvements after the time they are constructed by the seller-tenant, a warranty deed of improvements not yet constructed would not serve to create any present interest in the improvements on the date the deed is delivered. Accordingly, such a deed should not be sufficient to allow a title insurer to insure the buyer-landlord’s interest in the improvements at the inception of the sale-leaseback transaction (although, as discussed above, because of the
established common law, courts are more likely to honor (and title insurers to rely on) lease provisions calling for automatic vesting of improvements constructed after the beginning of the lease term). See generally Strum, supra, and Thomas C. Homburger et al., Unresolved Questions of Sale-Leaseback Transactions — A Look at Real Estate, Tax and Bankruptcy Law Issues, 19 Real Prop.Prob. & Tr.J. 941 (Winter 1984).

b. [5.42] Protection of Buyer-Landlord's and Seller-Tenant's Interests in the Improvements

One of the buyer-landlord's concerns in a sale-leaseback transaction is the nature of the improvements to which it will succeed to title upon termination of the ground lease. When the seller-tenant retains title to the improvements and the buyer-landlord is relying solely on an automatic vesting lease provision, the buyer-landlord must be concerned with the seller-tenant's ability to deal with the improvements in any manner the seller-tenant pleases during the term of the lease. In Mid-Continent Petroleum Corp. v. Donelson, 189 Okla. 273, 116 P.2d 721 (1941), the court held that the landlord had no cause of action against a tenant who removed his improvements before the end of the lease term since, by the terms of the lease, the landlord had no interest in the improvements until the lease was terminated. To ensure that the seller-tenant cannot remove the improvements before the end of the lease term without the buyer-landlord's consent, the buyer-landlord should (1) place a provision in the ground lease that prevents the seller-tenant from removing any improvements without the buyer-landlord's consent and providing that any attempt to do so will constitute a default under the ground lease that immediately terminates the lease, or (2) structure the transaction so that the buyer-landlord has a present interest in the improvements by using, for example, the estate for years structure discussed in §5.41 above. Absent solutions such as those described above, the buyer-landlord, under common law, may lose the right to determine the nature of the improvements that will be received when the ground lease terminates.

When the seller-tenant retains title to the improvements until the lease is terminated, the seller-tenant should be concerned with how to protect its interest in valuable improvements if the lease is terminated early in the lease term because of a default by the seller-tenant. In this case, the buyer-landlord will receive a windfall since the buyer-landlord has paid for the land only. To protect its interest, the seller-tenant should consider a lease provision that provides that if the lease is terminated before a certain amount of time has passed, the buyer-landlord must pay an agreed-on sum for the improvements, that the seller-tenant has a lien for this sum, and that the seller-tenant can remain in possession until this sum is paid. See, e.g., Cohen v. East Netherland Holding Co., 258 F.2d 14 (2d Cir. 1958), which provides support for this type of provision.

The buyer-landlord may well refuse to agree to a provision for a payment to the seller-tenant if the lease terminates earlier because of a default, taking the position that in the event of an early termination of the ground lease by reason of the seller-tenant's default, the value of the improvements constitutes liquidated damages. Consideration should be given by the buyer-landlord to stating (1) this liquidated damages rationale clearly in the lease, and (2) that liquidated damages are sustainable (i.e., damages would be difficult to ascertain and the liquidated damage amount is reasonable (810 ILCS 5/2-718(1)) in order to avoid the seller-tenant's argument that forfeiture of valuable improvements constitutes an unenforceable penalty under the lease.
In most sale-leaseback transactions, the parties contemplate that the seller-tenant’s improvements will become the buyer-landlord’s property at the end of the lease term. However, a seller-tenant may desire to retain the right to remove the improvements, or the buyer-landlord may want the right to request the seller-tenant to remove the improvements.

A seller-tenant, by express agreement, may retain the right to remove improvements it constructs on the buyer-landlord’s property. In Illinois, unless the parties’ agreement provides otherwise, the seller-tenant can exercise its right to remove the improvements only before the lease terminates. See, e.g., Empire Building Corp. v. Orput & Associates, Inc., 32 Ill.App.3d 839, 336 N.E.2d 82 (2d Dist. 1975); Dreiske v. People’s Lumber Co., 107 Ill.App. 285 (1st Dist. 1903). If the seller-tenant is given a right to remove its improvements, the buyer-landlord should require the seller-tenant to remove all its improvements and return the property to the original condition. Since the seller-tenant’s right to remove its improvements ends when the lease is terminated, the seller-tenant may want additional time to remove its improvements or, alternatively, to require the buyer-landlord to pay for the improvements. Some Illinois courts allow the tenants to exercise their right to remove improvements within a reasonable time after termination of the lease. See, e.g., Getzendaner v. Erbstein, 341 Ill.App. 594, 94 N.E.2d 746 (1st Dist. 1950); Revzen Business Interiors, Inc. v. Carrane, 72 Ill.App.3d 601, 391 N.E.2d 24, 28 Ill.Dec. 825 (1st Dist. 1979). Furthermore, in some jurisdictions, the tenant is generally accorded a reasonable time after termination of the lease to remove its improvements. See, e.g., Paulina Lake Historic Cabin Owners Ass’n v. U.S.D.A. Forest Service, 577 F.Supp. 1188 (D.Or. 1983); Coleman v. Owens, 254 S.W.2d 341 (Ky.App. 1953); Tilchin v. Boucher, 328 Mich. 355, 43 N.W.2d 885 (1950).

A seller-tenant’s right to remove its improvements does not give the buyer-landlord the right to require the seller-tenant to remove improvements, and, in the absence of a lease provision to the contrary, the seller-tenant is not required to remove all of its improvements or to return the property to its original condition. See, e.g., Savage v. University State Bank of Champaign, 263 Ill.App. 457 (3d Dist. 1931); Duvanel v. Sinclair Refining Co., 170 Kan. 483, 227 P.2d 88 (1951); Fox v. Cities Service Oil Co., 201 Okla. 17, 200 P.2d 398 (1948); Gulf Oil Corp. v. Horton, 143 S.W.2d 132 (Tex.Civ.App. 1940); Arkansas Fuel Oil Co. v. Connellee, 39 S.W.2d 99 (Tex.Civ.App. 1931). The buyer-landlord who is concerned about receiving badly deteriorated or useless improvements that may have a negative value should provide in the lease that, at the buyer-landlord’s option upon notice from the buyer-landlord to the seller-tenant, the seller-tenant will remove all improvements it has placed on the leased premises upon termination of the lease term and return the premises to the original condition.

3. Forms

a. [5.43] Provisions Relative to Fixtures

1. “Building Fixtures” shall mean all plumbing, heating, lighting, electrical, and air-conditioning fixtures and equipment and all other fixtures, equipment, and articles of personal property used in the maintenance or operation of the buildings, structures, and improvements situated on the Demised Premises (as distinguished from operations incident to the business of Tenant and of any tenants and occupants of such buildings, structures,
and improvements holding through Tenant) that are either attached to or situated in or on the Demised Premises or any buildings, structures, and improvements now or after this date located thereon or therein. The Building Fixtures shall be and remain a part of the real estate and shall constitute the property of Landlord.

2. “Tenant’s Equipment” shall mean all trade fixtures and all personal property, fixtures, apparatus, machinery, and equipment now or after this date located in the buildings, structures, and improvements situated on the Demised Premises, either owned by Tenant and incident to the business of Tenant conducted in such buildings, structures, and improvements or owned by any other tenants and occupants of such buildings, structures, and improvements holding through Tenant, whether or not they are affixed thereto. All of Tenant’s Equipment shall be and remain the personal property of Tenant or such other occupants.

The Tenant’s Equipment may be removed from time to time by Tenant or other occupants of the Demised Premises; provided, however, that if such removal shall injure or damage the Demised Premises or the buildings, structures, or improvements thereon, Tenant shall repair the damage and place the premises and the buildings, structures, and improvements in the same condition as they would have been if such equipment had not been installed.

b. [5.44] Provision for Use in Ground Lease When Tenant Reserves Estate for Years in Buildings Until Expiration of Lease

“Buildings” shall mean all buildings, structures, and improvements now located on the real estate and all Building Fixtures, together with any and all buildings, structures, improvements, and Building Fixtures at any time after this date erected, constructed, or situated in or on the Demised Premises, or any part of the Demised Premises, during the continuance of the term of the Lease, and together with any and all other Building Fixtures after this date affixed or attached to or located on or within any such building, structure, or improvement or Building Fixture. For purposes of this definition of “Buildings,” building structures and improvements include (in addition to Building Fixtures), but are not limited to, all footings, foundations, appliances, machinery, piping, sewers, retaining walls, landscaping, streets, equipment, apparatus, fixtures reasonably deemed to be part of the Demised Premises, and all personal property of every kind and description presently or after this date situated, placed, or constructed on the Demised Premises and not included within the definition of “Building Fixtures” or “Tenant’s Equipment.”

In and by a warranty deed of even date with this instrument from Tenant to Landlord (Warranty Deed), Tenant has excepted and reserved an estate in the Buildings for a term of years, ending ________, 20__. It is expressly understood and agreed that in the event of the termination of the leasehold estate under this instrument prior to ________, 20__, the estate for years in the Buildings so excepted and reserved shall forthwith cease, without any act by either party, and Landlord shall automatically, without payment therefor, be and become the absolute owner of and vested with full title to and ownership of the Buildings, free and clear of all rights or claims of Tenant and all persons after this date claiming by, through, or under Tenant. It is the intention of the parties by this Section.
1. that the estate of Tenant in and to the Buildings shall constitute a retained
continuing interest in the Buildings for and during the duration of this Lease and
shall constitute real estate and not personal property;

2. that, subject to the continuing interest in the Buildings by Tenant for and during the
duration of this Lease, Landlord has acquired a present interest in the Buildings,
the interest to constitute real estate and not personal property and being the residue
of the full ownership of and title to the Buildings after the expiration of Tenant’s
estate in the Buildings so reserved and retained by Tenant; and

3. that by the recording of the Warranty Deed and of a short-form lease in accordance
with the provisions of this Lease, Landlord’s rights in and to the Buildings are by
this instrument made prior and superior to any and all rights in and to the
Buildings that may after this date be created or arise, whether by act of Tenant or
by operation of law.

It is the intention and agreement of the parties that Tenant’s interest in this Lease and
all of Tenant’s right, title, and interest in and to the Buildings shall be non-separable and
that any attempts to transfer or mortgage either of the interests shall be void and ineffective
unless there shall be a complete transfer or mortgage, as the case may be, of Tenant’s
interest in this Lease and of all Tenant’s right, title, and interest in and to the Buildings to
the same party.

Although the provisions of this instrument are intended to be self-executing, Tenant
hereby agrees, upon such earlier expiration or termination of this Lease, to execute any
further deed, bill of sale, or document requested by Landlord to confirm Landlord’s sole
ownership of and fee simple title to the Buildings and to warrant and defend Landlord’s
title to the Buildings against the claims of all persons except persons claiming by, through,
or under the Landlord. Tenant hereby irrevocably appoints Landlord as its attorney in fact,
coupled with an interest, to execute, acknowledge, and deliver on its behalf such deed, bill of
sale, or document.

Tenant’s estate or interest in the Buildings, as distinguished from its leasehold interest,
shall not extend to any airspace or property other than the Buildings nor to any airspace
occupied by the Buildings.

Notwithstanding anything to the contrary, the exception and reservation of an estate for
a term for years in the Buildings contained in the Warranty Deed shall in no way affect
Tenant’s rights to depreciate the Buildings (including additions thereto built by Tenant on
the Demised Premises). Landlord agrees, while the estate for years in the Building remains
in Tenant, not to claim any depreciation of its interest in the Buildings.

NOTE: In the provision above, “Demised Premises” is defined to mean land only.
c. [5.45] Form of Deed When Grantor Reserves Estate for Years in Buildings Until Expiration of Ground Lease

[Grantor conveys to Grantee] all that certain real estate, with the buildings and improvements on that real estate legally described as follows:

[legal description of real estate]

TOGETHER WITH the appurtenances and all the estates and rights of Grantor in and to said premises.

EXCEPTING AND RESERVING unto Grantor until [date of expiration of last renewal term of the lease], or until the earlier expiration or termination of the Lease, an estate in and to any and all Buildings and Building Fixtures, it being intended and agreed hereby that such estate so excepted and reserved unto Grantor and all the interest in the Buildings and Building Fixtures by this instrument conveyed to Grantee shall each constitute real estate and not personal property.

Simultaneously with the acceptance of this deed, Grantee is leasing back to Grantor the real estate and premises being conveyed by this instrument pursuant to a certain Lease (Lease) of even date herewith. It is the intention of Grantor and Grantee that title to the real estate being conveyed by this instrument shall be separated from the estate or interest in the Buildings and Building Fixtures. The estate or interest in the Buildings and Building Fixtures is excepted and reserved by Grantor as stated above until the earlier of [date of expiration of last renewal term] or the expiration or termination of the Lease, on which the estate for years by this instrument reserved and all estate and interest of Grantor in the Buildings and Building Fixtures shall terminate and the Buildings and Building Fixtures shall be surrendered to Grantee or its successors, and assigns, all as more particularly set forth in Section _____ of the Lease, the provisions of which are by this instrument incorporated herein by reference as if fully set forth herein. The estate or interest in the Buildings and Building Improvements by this instrument excepted and reserved by Grantor does not extend to any airspace or property other than the Building, nor to any airspace occupied by the Building. A Memorandum of Lease is intended to be recorded immediately following the recording of this deed.

NOTE: “Buildings,” “Building Fixtures,” and “Tenant Equipment” are defined in §§5.43 and 5.44 above.

J. Non-Disturbance, Subordination, and Mortgaging of Fee and Leasehold

1. [5.46] Mortgaging of Fee

If the landlord wishes to be in a position to obtain mortgage financing on the strength of the lease, it may require an agreement by the tenant to subordinate the lease to future mortgages if the landlord so request. Absent a subordination of the lease to a future fee mortgage upon
foreclosure, the fee mortgagee will take the property subject to the terms of the lease. The greater burden to the mortgagee’s security in such a case may well be reflected in higher interest rates. As stated by the court in Reichert v. Bankson, 199 Ill.App. 95, 97 – 98 (4th Dist. 1916), quoting with favor from Herbert Thorndike Tiffany’s book entitled LANDLORD AND TENANT, p. 876:

If the interest of the landlord is sold under a judgment, mortgage or other lien, which is subsequent to the lease, the purchaser becomes the landlord in the former owner’s place, since the reversion passes by the sale. In such case the purchaser takes only what the lessor has, that is, his estate in reversion, and the rights of the tenant under the outstanding lease remain such as they would be in the case of a voluntary transfer of the reversion. If, on the other hand, the premises are sold under a judgment, mortgage or other lien prior to the lease, the purchaser comes in by title paramount to the lease, and he is entitled to possession as against the tenant thereunder. And as the tenant under a lease has no rights in the land as against the purchaser under a prior incumbrance, so such purchaser has, apart from statute, no rights as landlord against such tenant, unless the latter accepts a new lease from the purchaser, or, which is the same thing, attorns to him.

In the past, the cases in Illinois, including the case cited above, followed the title theory of mortgages, that a mortgagee has title paramount to all other interests subsequent to the execution of the mortgage. Under this theory, if the lease is executed prior to the mortgage, the mortgagor-landlord mortgages only the interest that it owns — its equity of redemption. If the mortgage is recorded prior to execution of the lease, the mortgagor-landlord has mortgaged the entire interest in the realty, and, consequently, when it executes a subsequent lease, that lease is carved out of the equity of redemption and remains subject to all rights of the mortgagee.


Although the above cases provide precedent regarding the issues before the court, we cannot follow them for the following reasons. The cases apply the rule that a mortgagee has paramount title and has the right of possession against all other interests subsequent to the execution of the mortgage. However, the State of Illinois has recently adopted the “lien theory of mortgages,” and a mortgagee is not deemed to own the title of the property but only a mere lien. (Harms v. Sprague (1984), 105 Ill.2d 215, 222 – 23.) The adoption of the lien theory of mortgages created a legal environment where many issues of mortgage law remained unresolved. . . . [T]he question of whether a mortgage foreclosure cuts off the rights of junior lessees in Illinois has never been definitively decided, because a lease has been cut off upon a mortgagee’s taking possession prior to foreclosure; however, now that a mortgagee is deemed to have only a lien and not title prior to foreclosure, Illinois courts would have the opportunity to determine the scope of the lessee’s rights since the lease
would not be cut off merely by the mortgagee’s entry into possession. ... Similarly, there has been no reported case in Illinois which deals with the possessory rights of a mortgagee whose interest is derived from a lien rather than a title. [Citations omitted.] 551 N.E.2d at 423.

Under the lien theory, even though the mortgage is recorded prior to execution of the lease, the lease will survive the mortgagee’s possession prior to foreclosure and bind both the tenant and the mortgagee. The Illinois Mortgage Foreclosure Law, 735 ILCS 5/15-1101, et seq., was also changed to support this outcome. Section 15-1701 of the Law provides that “[t]he holder of the certificate of sale or deed . . . shall be entitled to possession of the mortgaged real estate, as of the date 30 days after the order confirming the sale is entered,” until which time the lessee retains a leasehold interest. Furthermore, the lessee cannot be evicted unless personally named as a party to the foreclosure or forcible entry and detainer. Id. See also Agribank, FCB v. Rodel Farms, Inc., 251 Ill.App.3d 1050, 623 N.E.2d 1016, 191 Ill.Dec. 426 (3d Dist. 1993). Under these circumstances, fee mortgage lenders may require the mortgagor-landlord to accept the same terms and conditions regarding future leases into the mortgage.

Some fee mortgage lenders are careful to see that the lease is prior to the mortgage so that, following foreclosure, the lease will survive. If the lease is a reasonable one, the fee may be more salable if the foreclosing mortgagee can sell both the reversionary interest in the land and the improvements and the income-producing potential of the property during the term of the lease through continued realization of the rental stream.

The best method of handling the problem of lease subordination to a fee mortgage is to give the landlord the election, in the future, either to keep the lease ahead of future mortgages or to subordinate the lease to future mortgages. This allows the landlord the ultimate flexibility to comply with the then-unknown desires of a future fee mortgagee, although many tenants will not agree to a subordination of the lease to a fee mortgage.

If the lease contains a purchase option in favor of the tenant, the lease should limit the principal amount of any fee mortgage loan to an amount less than the purchase price and should require that the landlord reserve necessary prepayment rights so that the tenant will be able to obtain title free and clear of the mortgage without paying more than the option price. The tenant may also wish to require that any fee mortgage permits (or at least does not prohibit) the transfer of the fee title to the land and the landlord’s future interest in the buildings and improvements from the landlord to the tenant so that, if the tenant acquires title to the land and to the landlord’s reversionary interest in the buildings and improvements, the tenant can continue to enjoy the benefits of the fee mortgage.

In structuring the lease, the landlord should attempt to make the tenant’s obligations with respect to the property coextensive with the landlord’s obligations as mortgagor under any fee mortgage known at the time the lease is executed. Since the landlord is principally a passive investor with little or no rights of control over the property in the absence of a default by the tenant, the lease will have to obligate the tenant to maintain the property in accordance with the requirements of the mortgage. A default by the tenant in performing these obligations will be a default under the lease giving rise to all of the landlord’s rights upon default (including the right...
to perform the tenant’s obligations at the tenant’s expense). If a period to cure defaults is given in
the lease, it should be shorter than any cure period for the same default provided in the mortgage
so that the landlord will have adequate time to effect a cure of the mortgage default if the tenant
fails to meet the mortgage obligations. In addition, as discussed above (see §§5.23 and 5.36), the
fee mortgagee’s rights with respect to insurance and condemnation proceeds must be consistent
with the rights of the tenant under the lease to the insurance and condemnation proceeds.

2. [5.47] Leasehold Financing

Quite commonly, the seller-tenant procures permanent financing through a combination of
the proceeds of a sale and leaseback transaction and the proceeds of a leasehold mortgage loan
secured by a pledge of the seller-tenant’s leasehold interest and, if the seller-tenant has title to the
improvements, by a pledge of seller-tenant’s rights in the improvements. In addition, once the
sale and leaseback is consummated, the only way the seller-tenant can borrow money to finance
any alteration or addition to the improvements, using the improvements as security, is through
leasehold financing.

If the seller-tenant wishes to be in a position to obtain financing by leasehold mortgage, not
only should this right be reserved in the lease, but the lease should contain provisions protecting
the rights of the leasehold mortgagee in and to the security for its land, including

a. adequate notice of default to the leasehold mortgagee and opportunity to cure defaults,
   including a sufficient time to conclude a foreclosure if this is required to enable the
   leasehold mortgagee to cure the defaults;

b. avoidance of termination of the lease by reason of the seller-tenant’s bankruptcy or
   insolvency since these are defaults that the leasehold mortgagee cannot cure or, if such
   contingencies remain in the lease, an agreement by the buyer-landlord to give the
   leasehold mortgagee a new lease upon termination of the original lease by reason of the
   seller-tenant’s default;

c. provisions regarding the rights of the leasehold mortgagee under casualty insurance
   policies, including the affixing of a mortgage clause in favor of the leasehold mortgagee;

d. provisions exonerating the leasehold mortgagee from personal liability, at least until the
   leasehold mortgagee acquires the leasehold estate through the foreclosure, and making
   inapplicable to the purchaser at a foreclosure sale any requirements for assumption of any
   liability of the prior tenants arising before the purchase; and

e. provisions permitting the leasehold mortgagee to exercise any options conferred on the
   seller-tenant and to receive payment of any money payable to the seller-tenant.

As stated in §5.46 above, the leasehold mortgage must conform with the terms of the ground
lease with respect to availability of insurance and condemnation proceeds.
On occasion, a buyer-landlord will agree to subordinate its fee as additional security for the seller-tenant’s mortgage in order to assist the seller-tenant in obtaining mortgage financing at a more favorable rate or to make financing available to a seller-tenant with a questionable credit record. The ability of the seller-tenant to perform the economic terms of a sale and leaseback transaction may well turn on the availability of reasonable leasehold financing interest rates. The effect of a subordination of the fee by the buyer-landlord is a pledge of the buyer-landlord’s reversionary interest in the land and improvements as additional security for the loan to the seller-tenant. Thus, the mortgagee has received a pledge of all legal interests in the property — the seller-tenant’s leasehold interest in the land and present interest in the improvements (if any), and the buyer-landlord’s reversionary interest in the land and improvements — and can foreclose out all interests in the property upon the seller-tenant’s default in the same way as a mortgage on a fee interest without a lease could be foreclosed. The buyer-landlord does not sign the mortgage note or assume any personal liability for the mortgage debt; the buyer-landlord simply pledges its interest in the property as security for the loan.

A foreclosure of a mortgage, when the buyer-landlord has subordinated its fee, will jeopardize the buyer-landlord’s fee interests in the premises. Accordingly, a buyer-landlord who has subordinated its fee will normally insist that the mortgage loan be amortized, by its own terms, before the end of the lease term and that the mortgage contain a provision giving the buyer-landlord notice of the seller-tenant’s default and an opportunity to cure the default for a period that is longer than the cure period granted the seller-tenant (thus enabling the buyer-landlord to cure the default and preserve the estate). The lease will also provide that a default under the mortgage will be a default under the lease, entitling the buyer-landlord to terminate the lease or to exercise any of the other remedies available to the buyer-landlord in case of the seller-tenant’s default under the lease that the buyer-landlord must cure.

If the buyer-landlord and the leasehold mortgagee are the same person, a danger exists that a court may construe the sale-leaseback and the leasehold mortgage transactions as part of one mortgage financing transaction in which the landlord-lender can exercise its rights only through foreclosure. This danger would seem to be exacerbated if the sale-leaseback and leasehold mortgage transactions were entered into simultaneously and the documents for the two transactions contain cross-default provisions. If the landlord and mortgagee are the same and the landlord-mortgagee is entitled to proceed under either the lease or the mortgage, the landlord-mortgagee would be more likely to exercise its speedier remedies under the lease documents (allowing the recovery of title to both land and improvements free of liens created on the leasehold estate or the tenant’s interest in the improvements) than to exercise its rights as mortgagee. Since most mortgage foreclosure statutes provide a mortgagor with greater protection before the mortgagor is deprived of the equity of redemption than is provided at law for a defaulting tenant, the mortgagor tenant loses its “day in court” under the protection of the applicable foreclosure act if the landlord-mortgagee proceeds under the lease. Courts in this era, when judicial recharacterizations of one form of interest into another (especially in the context of a bankruptcy) are becoming more common, would be likely to look hard at this type of situation in order to allow the mortgagor-tenant to benefit from the protections of the applicable mortgage foreclosure act and the Bankruptcy Code.
The landlord-mortgagee’s best defense to such an argument would appear to be that the landlord-mortgagee should not be penalized because it also made additional money available to the tenant-mortgagor under the leasehold mortgage format and that the tenant-mortgagor entered into this type of dual transaction knowingly, aware of its risks. Under the rationale of MacArthur v. North Palm Beach Utilities, Inc., 202 So.2d 181 (Fla. 1967), the landlord should not be prejudiced just because it accommodated its tenant by providing leasehold financing, particularly since the tenant will end up in the same position it would have been in had the landlord and leasehold mortgagee been different persons. In either case, the defaulting tenant would lose its title and right to possess the land and the improvements. The only difference would be that when the landlord is also the leasehold mortgagee, the tenant-mortgagor would lose these rights more quickly since there would be no required foreclosure. When the parties are sophisticated and the tenant-mortgagor enters into dual sale-leaseback and leasehold mortgage transactions knowing that it may lose its rights in the improvements upon a default under the ground lease, the courts should not penalize the landlord-mortgagee by forcing it to go through foreclosure when the parties consciously chose the structure of the transaction. Courts have found, when sophisticated parties have entered into a sale-leaseback format, that the seller-tenant cannot subsequently reject the format chosen when the buyer-landlord seeks to enforce its legal rights. In re Kassuba, 562 F.2d 511 (7th Cir. 1977); In re San Francisco Industrial Park, Inc., 307 F.Supp. 271 (N.D.Cal. 1969). Conversely, a tenant-mortgagor who wishes to avoid the loss of its “day in court” because a default under a leasehold mortgage triggers a default under the ground lease should see that the lease does not provide that a default under the leasehold mortgage is a default under the lease. If the tenant-mortgagor agrees to full cross-default provisions in this type of complex and sophisticated transaction, the tenant-mortgagor should be bound by its agreement.

3. **[5.48] Non-Disturbance Agreements with Occupancy Tenants**

At times, it may be in the best interests of the buyer-landlord, the seller-tenant, and a mortgagee whose mortgage is prior to the rights of the seller-tenant’s subtenants to enter into a subordination non-disturbance agreement with the various occupancy subtenants to whom the seller-tenant has leased portions of the improvements. Such an agreement will ensure the subtenants continued use of the leased premises in the event of a termination of the lease or a foreclosure of either a leasehold or fee mortgage and will help reduce the possibility of a claim by the subtenants against the seller-tenant for breach of any covenant of quiet enjoyment contained in the subleases. This protection will induce occupancy tenants to enter into subleases of the property, thus helping ensure the economic success of the sale-leaseback and financing transactions. In addition, such agreements will help ensure to the buyer-landlord in the event of a termination of the underlying lease, and to the mortgagee in the event of a foreclosure, that the occupancy tenants will remain in possession and will continue paying rent. See §5.55 below for a sample of a conditional assignment of subleases from the seller-tenant to the buyer-landlord.

4. **Forms**

a. **[5.49] Provision Permitting Leasehold Mortgage**

Tenant and its successors and assigns shall have the right to mortgage or pledge this Lease and Tenant’s interest in the buildings and improvements on the Demised Premises, in
whole or in part, provided that any mortgage or pledge shall include the entire interest in each or, in case of a mortgage or pledge of a part interest, the same fractional interest in each, to the end that the lien or title of the mortgagee or pledgee in this Lease and in the buildings and improvements, whether in whole or in part, shall be inseparable. Any leasehold mortgage shall be subject and subordinate to the rights of Landlord under this Lease both in the land and in the buildings and improvements, including Landlord's rights in and to the buildings and improvements upon the termination of this Lease. Any mortgage shall provide in substance that in the event of a foreclosure of mortgage or of any other action or proceedings for the enforcement thereof or of any sale thereunder, the leasehold estate under this Lease and Tenant's interest in the buildings and improvements shall be sold as one parcel. No holder of any leasehold mortgage shall be entitled to any rights or benefits under or by virtue of the provisions of this paragraph or of [the paragraph giving rights to the leasehold mortgagee], nor shall the provisions of this paragraph be binding on Landlord unless and until an executed counterpart of the leasehold mortgage, or a copy thereof certified by the mortgagee to be true, or a copy thereof certified by the recording officer of the county in which the mortgage is recorded, shall have been delivered to Landlord and Landlord shall have been duly notified by Tenant or by the mortgagee under the mortgage of the name and address of the mortgagee.

b. [5.50] Provision Giving Certain Rights to Leasehold Mortgagee

If Tenant or its successors or assigns shall mortgage this Lease in accordance with the provisions of this Lease and Landlord shall have been given due notice thereof as provided in this Lease, provided that the mortgage shall have been given as security for a bona fide loan of money of not less than $_______ made to Tenant and shall be owned and held by a person having no financial interest in or connection with Tenant, the following provisions shall apply as long as the leasehold mortgage shall remain unsatisfied of record or (to the extent applicable) after acquisition of the leasehold estate pursuant to any foreclosure of the leasehold mortgage or in lieu of foreclosure thereof:

1. Landlord and Tenant shall not enter into any agreement providing for surrender or modification of this Lease without the prior consent in writing of the mortgagee under such mortgage.

2. Landlord shall not be empowered to terminate the leasehold estate under this Lease by reason of the occurrence of any default unless Landlord shall have served on the mortgagee under the leasehold mortgage, at the address furnished to Landlord and otherwise in the manner provided below for the service of notice, a notice of default such as Landlord may be required by the terms of this Lease to serve on Tenant.

3. Any such mortgagee shall have the right to remedy any default under this Lease or cause it to be remedied, and Landlord shall accept such performance by or at the instance of such mortgagee as if performance had been made by Tenant. There shall be added to any grace period allowed by the terms of this Lease to Tenant for curing any default an additional period of ________ for the mortgagee to cure the default beyond the time
allowed to Tenant. If the mortgagee shall fail to remedy any such default within any such additional period of time, Landlord may then pursue all remedies in accordance with the default provisions of this Lease.

4. Any money held by Landlord under the provisions of this Lease that may be or become payable to Tenant (including, but not limited to, deposits for payment of real estate taxes, proceeds of casualty insurance, or proceeds of condemnation awards) shall be payable upon demand to the mortgagee under any leasehold mortgage as the interest of such mortgagee may appear. If Landlord should at any time be in doubt as to whether this money is payable to the mortgagee or to Tenant, Landlord may pay this money into court and file an appropriate action of interpleader in which all of Landlord's cost and expenses, including attorneys' fees and costs, shall first be paid out of the proceeds so deposited.

5. No mortgagee under any leasehold mortgage or holder of indebtedness secured thereby or purchaser at a foreclosure sale shall incur or be required to assume liability for the payment of rental under this Lease or for the performance of any of Tenant's covenants and agreements contained in this Lease unless and until such mortgagee or holder of indebtedness shall have become the owner of the leasehold estate under this Lease by foreclosure or by assignment in lieu of foreclosure, whereupon the liability of this person shall be only that as may arise thereafter by operation of law or by reason of privity of estate.

6. Casualty insurance policies may contain mortgage clauses covering the mortgage as the interest may appear provided that they contain an express recital that the rights of the mortgagee are at all times subject to the rights of Landlord under this Lease.

K. [5.51] Covenant of Quiet Enjoyment

Under Illinois law, a covenant of quiet enjoyment by the landlord will be implied even if not specifically provided in the lease. Wade v. Halligan, 16 Ill. 507 (1855); Sixty-Third & Halsted Realty Co. v. Chicago City Bank & Trust Co., 299 Ill.App. 297, 20 N.E.2d 162 (1st Dist. 1939). Accordingly, since the buyer-landlord will have acquired title to the property from the seller-tenant, any covenant of quiet enjoyment by the buyer-landlord should be limited to the acts of the buyer-landlord and those claiming under the buyer-landlord (other than the seller-tenant). Any other format would lead to a probable circuity of action. Some leases further limit the covenant of quiet enjoyment by providing that the covenant is effective only as to the original landlord. Assignees of the original landlord take their interest free of the covenant of quiet enjoyment. This addition may make the original landlord's right of reversion more readily salable.

L. Assignments and Subleases

1. [5.52] Assignment of Lease by Tenant

There is no uniform policy regarding the assignment of a tenant's interest to a successor. Absent a provision to the contrary, a tenant has the right to assign its interest under a lease.
§5.52  


Since the lease is for a relatively long term, there is seldom an absolute restriction against assignment. In some instances (e.g., the lease provides for percentage rent payment and the buyer-landlord believes a particular seller-tenant will produce substantial percentage rents), assignments without the buyer-landlord’s consent are limited to assignees that are corporate affiliates of the seller-tenant or successors to the seller-tenant’s business. At times, a prohibition against assignment without the buyer-landlord’s consent is tempered by a provision that the buyer-landlord’s consent will not be unreasonably withheld or delayed. Under Illinois law, even if the lease does not contain a provision that the buyer-landlord will not unreasonably withhold its consent to an assignment of the seller-tenant’s interest, the buyer-landlord may not withhold its consent unless it has commercially reasonable grounds, based on specific facts, for so doing. Regent v. Dempsey-Tegler & Co., 70 Ill.App.2d 32, 216 N.E.2d 500 (5th Dist. 1966); Mowatt v. 1540 Lake Shore Drive Corp., 385 F.2d 135 (7th Cir. 1967). If the buyer-landlord has reserved the right to consent to the seller-tenant’s assignment, however, the seller-tenant will not be willing to rely on the Illinois caselaw described above with respect to the buyer-landlord’s consent to assignment. The seller-tenant will want the protection of standards enunciated in the lease governing the buyer-landlord’s approval and of lease provisions requiring the buyer-landlord to reply promptly to a request for approval of assignment and to state the reasons for any disapproval. In addition, the seller-tenant may seek a provision that a buyer-landlord’s failure to respond within a specified time period will be deemed to be an approval by the buyer-landlord.

Leases usually provide that a permitted assignment must be recorded and must include an assumption of the lease by the assignee and that a copy of the assignment or notice thereof must be served on the buyer-landlord.

If the improvements themselves afford good security and the credit of the seller-tenant is not a material factor in the transaction, provision is often made to relieve each successive tenant-assignor of liability upon assumption by an assignee of the tenant’s obligations under the lease. If, however, the creditworthiness or business reputation of the seller-tenant is important to the landlord, the buyer-landlord may want to provide that the seller-tenant’s liability under the lease survives an assignment of the seller-tenant’s interest under the lease.

In order to facilitate leasehold financing, the lease should contain a provision granting a leasehold mortgagee who forecloses or takes title to the leasehold estate by deed in lieu of foreclosure the right to assign the lease without the buyer-landlord’s consent. This right is important to leasehold mortgagees since most lenders are not in the business of operating property and will be seeking a purchaser for that leasehold as soon as they can obtain title.

Note that under §365(f) of the Bankruptcy Code, in the event of a tenant’s bankruptcy, lease provisions prohibiting or restricting assignments by the tenant of the leasehold estate are invalid if the lease is assumed and the conditions for curing the tenant’s defaults and giving adequate assurances of future performance by the assignee are met. 11 U.S.C. §365(f). See §5.7 above for a more complete discussion of the rights of assignment under the Bankruptcy Code.
2. [5.53] Subletting of Portions of Property by Tenant

If the use of the premises is intended to be restricted, then, normally, the right to sublet would be restricted in the same way that the right to assignment would be restricted. On the other hand, if the improvements are intended for rental (for example, an office building, shopping center, or high-rise apartment building), then there will be no restriction on subleasing portions of the premises although there may still be a restriction against subleasing all or substantially all of the premises without the buyer-landlord’s consent. In addition, the lease may require that subleases be made expressly subject to the right of the buyer-landlord and that no subleasing will relieve the seller-tenant from its duties under the lease.

In many cases, the lease will include an assignment by the seller-tenant under the underlying lease of all rentals and of the sub lessor’s rights under subleases, given for the purpose of securing the payment of rent under the underlying lease. The assignment should assist the buyer-landlord, if the underlying lease is terminated, to establish privity with the seller-tenant’s sublessees and to enforce the subleases if the buyer-landlord so desires. See §5.48 above.

3. Forms

a. [5.54] Provision Concerning Assignment of Tenant’s Interest

1. Except as otherwise provided in this article, Tenant shall not allow or permit any transfer by operation of law of this Lease or of any interest under this Lease or of Tenant’s interest in the building and improvements, or assign, convey, mortgage, pledge, or encumber this Lease or any interest under this Lease, or Tenant’s interest in the buildings and improvements, or permit the use or occupancy of the premises or any part thereof by anyone other than Tenant or Tenant’s subtenants, without, in each case, Landlord’s written consent first being obtained. No assignment or subletting (with or without Landlord’s consent) shall release Tenant from any of its obligations under this Lease.

2. Any assignment of this Lease by Tenant shall be evidenced by an instrument in writing (a copy of which shall be delivered to Landlord) duly executed and acknowledged by the assignor and the assignee and duly recorded in the recorder’s office of the county where the Demised Premises are situated, in which and through which the assignee shall expressly accept and assume all of the terms and covenants in this Lease contained to be kept, observed, and performed by Tenant and shall further acknowledge that all interest in the land and buildings and improvements situated therein acquired by virtue of this assignment is expressly subject to paramount rights of Landlord, including those under the provisions of this Lease providing for the succession of Landlord to full title to the buildings and improvements at the end of the term of this Lease.

3. No assignment, transfer, or mortgage of Tenant’s interest under this Lease shall be made or shall be valid unless any such assignment, transfer, or mortgage shall also include Tenant’s interest in the buildings and improvements, or, in case of a partial assignment and transfer of Tenant’s interest under this Lease, the same fractional interest in each, to the
end that the ownership of Tenant's interest in this Lease and in the buildings and improvements, whether in whole or in part, shall be inseparable. Tenant shall not assign or transfer or suffer or permit any transfer by operation of law of Tenant's interest in the buildings and improvements separate and apart from tenant's interest under this Lease.

4. Any attempted assignment, transfer, or mortgage in violation of any of the provisions of this Article shall be null and void and of no force and effect.

b. [5.55] Provision for Assignment to Landlord of Subleases Made by Tenant

1. Effective in the event of a default under this Lease that would entitle Landlord under the provisions of this Lease governing defaults to elect to terminate this Lease and reenter the premises, whether or not Landlord may have made such election, and, in any event, upon termination of this Lease (unless Landlord elects not to accept this assignment), Tenant hereby assigns to Landlord all of its right, title, and interest in and to the lease and lease and all rents due and to become due under the Lease and to all subleases hereafter made by Tenant for the buildings and improvements or portions thereof and all rents due and to become due under the leases. After the effective date of the assignment (unless Landlord has elected not to accept the assignment), Landlord is hereby empowered to collect, sue for, settle, compromise, and give acquittances for all of the rents that may become due under said leases and avail itself of and pursue all remedies for the enforcement of said leases and of Tenant's rights in and under said leases as Tenant might have pursued but for this assignment. The assignment contained in this section, at the expiration of the term of this Lease by lapse of time or otherwise, shall be and become absolute. Tenant represents and warrants that it has not collected and agrees that it will not collect any rent, income, and profits arising or accruing under any leases in advance of the time when they become due under the terms of the leases. Tenant further agrees that it will not assign or encumber its interest in any leases or in any of the rents, income, or profits thereof, except that Tenant may assign them to any assignee of its interest under this Lease or to any mortgagee under any leasehold mortgage.

2. As additional security for the payment by Tenant to Landlord of all rentals and other sums becoming due and owing by Tenant to Landlord under this Lease from time to time, Tenant has executed and delivered a separate assignment to Landlord of leases. Tenant agrees that any default by Tenant in the observance or performance of any of Tenant's covenants or agreements contained in said assignment shall constitute a default under this Lease.

See Chapter 6 of this handbook for a more detailed discussion of assignments and subleases.

M. [5.56] Seller-Tenant's Repurchase Options

There is no set pattern in regard to repurchase options. In the past, they were frequently avoided because of the income tax problems they entail. More recently, there has been a tendency to include these provisions, with due regard, of course, to tax consequences. It should be noted, however, that if there is a right in the buyer-landlord to put the fee to the seller-tenant or an
economic compulsion on the seller-tenant to exercise a repurchase option (e.g., because of a short lease term or a repurchase price substantially below fair market value), the transaction may be recharacterized as a loan, and, apart from the tax consequences, the buyer-landlord as mortgagee may find itself facing great difficulties in realizing on the security. Consequently, in the case of the seller-tenant’s default, the buyer-landlord as mortgagee will have to act without many of the rights it would otherwise reserve in a mortgage, such as a waiver of the right of redemption. Frito-Lay, Inc. v. United States, 209 F.Supp. 886 (N.D.Ga. 1962). See §5.11 above. In addition, it is probable that the buyer-landlord will be precluded from making a claim under the ALTA Owner’s Policy obtained at the time of acquisition because applicable policy exclusions will excuse the insurer from either indemnifying or defending the buyer-landlord.

In some instances, instead of a purchase option, the buyer-landlord will afford the seller-tenant a right of first refusal, giving the seller-tenant the privilege of meeting a bona fide offer received from a third-party purchaser the buyer-landlord is prepared to accept.

Buyer-landlords and seller-tenants have also used a device known as the “rejectable offer.” The seller-tenant is permitted to make an offer to the buyer-landlord for the purchase of the property at a fixed price or at a price to be computed under a definite formula. If the buyer-landlord rejects the offer, the seller-tenant may then terminate the lease. See Sun Oil Co. v. Commissioner of Internal Revenue, 562 F.2d 258, 267 – 268 (3d Cir. 1977), in which the court found that a rejectable offer that allowed the seller-tenant to repurchase the property for less than fair market value helped, for tax purposes, make the transaction in question a loan instead of a sale and lease.

The parties to a sale and leaseback transaction should also consider whether the seller-tenant’s repurchase option violates the rule against perpetuities. The rule against perpetuities generally holds that no estate in property shall be valid unless it must vest, if at all, not later than 21 years after the end of one or more lives in being at the creation of the estate. The rule seeks to ensure the productive use and development of property, free from extended restraints on alienation.

In Symphony Space, Inc. v. Pergola Properties, Inc., 88 N.Y.2d 466, 669 N.E.2d 799, 646 N.Y.S.2d 641 (1996), the New York Court of Appeals struck down the option component of a sale and leaseback transaction while allowing the rest of the transaction to stand. The parties to the sale and leaseback were corporations, and the option did not refer to any living persons as potential “measuring lives” for the rule against perpetuities. Thus, the option would be void under the rule if it could vest more than 21 years after its creation. The seller-tenant’s option in that case was created in 1978, but could be exercised as late as 2003. The option created an estate in land that could vest more than 24 years later and was thus void as against the rule against perpetuities. To avoid this result, seller-tenants should always include a “savings clause” in the option, providing that notwithstanding anything contained in the option to the contrary, the option shall terminate, if it has not previously terminated, 21 years after the death of the survivor of at least one of the individuals involved in the transaction. See Alvin L. Arnold, Sale-Leasebacks: Option Violates Rule Against Perpetuities, 26 Real Est.L.Rep. 3 (1996).
N. [5.57] Buyer-Landlord’s Purchase Options

In recent years, sale-leaseback transactions have included a right in the buyer-landlord to acquire the leasehold estate and improvements for an agreed-on sum at a point before the expiration of the lease term. Concerns have grown, however, about the enforceability of these options in light of the long-established common-law prohibition against “clogging the mortgagor’s equity of redemption.” See Howard E. Kane, The Mortgagee’s Option To Purchase Mortgaged Property, FINANCING REAL ESTATE DURING THE INFLATIONARY 80’S, p. 123 (1981) (Kane). The buyer-landlord’s option to acquire the leasehold estate and improvements is often a crucial element of the transaction from the buyer-landlord’s viewpoint. A finding that the buyer-landlord’s option was unenforceable by reason of the doctrine of clogging of the equity of redemption could have devastating effects on the buyer-landlord’s economic expectations from the transaction.

Clogging the equity of redemption is an equitable doctrine developed by the English Chancery Courts as a type of common-law consumerist remedy to protect the “impecunious landowner in the toils of a crafty moneylender.” Samuel v. Jarrah Timber & Wood Paving Corp., 1904 App.Cas. 323 (similar to unconscionability doctrine used today to protect unwary consumers). Essentially, the doctrine prohibits a lender in a mortgage transaction from exacting any agreement from a borrower that, upon full payment of the indebtedness plus legal interest, prevents the borrower from regaining the exact title, control, and use of the property it had before entering into the mortgage transaction. Thus, for example, a mortgagor could not, as part of the mortgage transaction, obtain an option to purchase the mortgaged property since the exercise of the option would prevent the mortgagor from regaining the property even if the debt and interest were fully paid.

In the United States, the clogging doctrine has, on occasion, been applied to render agreements between parties to a mortgage transaction unenforceable. For example, in Humble Oil & Refining Co. v. Doerr, 123 N.J.Super. 530, 303 A.2d 898 (1973), the leading modern American application of this doctrine, the New Jersey chancellor invalidated an option to purchase the mortgaged property, granted to a party acting in the nature of a guarantor, as an unenforceable clog.


In a sale-leaseback transaction in which the buyer-landlord buys and then leases land back to the seller-tenant and in which the buyer-landlord will succeed to full title to the improvements upon the termination of the lease, the clogging doctrine should not apply. The doctrine rests on
the theoretical underpinning that a borrower’s common-law equity of redemption must be returned to it in its pre-mortgage state if the borrower faithfully repays the loan. No such redemption rights arise in a sale and leaseback transaction. The seller-tenant has parted with its equity of redemption in the land upon consummation of the sale. After the sale, the only right of the seller-tenant in the land is a leasehold estate arising by virtue of the lease. The passing of title to the improvements occurs either by operation of law or, if some of the suggestions contained above are followed, by reason of the original instrument of conveyance when the land was sold.

The seller-tenant may allege, however, that the sale-leaseback transaction should be recharacterized as a financing device (e.g., an equitable mortgage) giving rise to an equity of redemption in the seller-tenant and, therefore, in a default under the ground lease, the buyer-landlord cannot gain title to the improvements without foreclosing the equity of redemption. See In re Kassuba, 562 F.2d 511 (7th Cir. 1977). If the sale-leaseback is the only transaction between the parties concerning that particular property and no purchase or repurchase options are granted to either the buyer-landlord or the seller-tenant, a court seems unlikely to find the transaction to be an equitable mortgage financing giving rise to redemption rights in the seller-tenant. However, when the seller-tenant receives an option to repurchase the land or the buyer-landlord also makes a loan to the seller-tenant with the improvements and leasehold estate as collateral, there is concern that the clogging doctrine could be invoked to invalidate a purchase option granted to the buyer-landlord, particularly if the buyer-landlord’s option to purchase the improvements was contained in the leasehold mortgage documents. This risk is diminished if the option is contained in the sale-leaseback documents. Kane, p. 138.

Even if a sale-leaseback (alone or in conjunction with leasehold financing from the buyer-landlord) is found to be a financing device in the nature of an equitable mortgage, an option of the buyer-landlord to purchase the leasehold estate and improvements before the end of the lease term may not be rendered unenforceable by a clog on the equity of redemption if (1) the equity of redemption was released in a subsequent transaction, (2) the option is a collateral advantage, or (3) the complex nature of the transaction and the sophistication of the parties render the doctrine inapplicable.

A debtor can release this equity of redemption in a subsequent transaction if there is adequate consideration and no fraud, oppression, or unfair advantage. See, e.g., Peugh v. Davis, 96 U.S. 332, 24 L.Ed. 775 (1878); Smith v. Shattls, 66 N.J.Super. 430, 169 A.2d 503 (1961). Accordingly, an option to the buyer-landlord to acquire the leasehold estate and improvements may withstand a challenge under the clogging doctrine if granted in a transaction subsequent to the sale and lease. However, the law regarding the amount of time required to separate the mortgage transaction from the release of the equity of redemption provides little guidance. In Reeve v. Lisle, 1901 App.Cas. 461, an 11-day separation was deemed sufficient. In Coursey v. Fairchild, 436 P.2d 35 (Okla. 1967), on the other hand, an 11-day gap between the date of the mortgage and the date of an oil and gas lease granted as additional consideration was held insufficient when the parties had agreed that these instruments formed part of a single transaction. Moreover, in Ringling Joint Venture II v. Huntington National Bank, 595 So.2d 180 (Fla.App. 1992), although the conveyance agreement resulting in taking the mortgagor’s right of redemption was created in conjunction with the mortgage documents, and therefore, it was not technically a “subsequent
agreement,” the court decided it was an agreement subsequent to the mortgage because the mortgageor received valuable consideration and it was not an unfair scheme. In order to decide whether a mortgageor releases its right of redemption in a “subsequent” transaction, the duration of time will not be a definitive factor.

A purchase right granted to the buyer-landlord may be supportable as a collateral advantage. As the clogging doctrine is applied to financing, additional rights in the debtor’s property granted to lenders may be enforceable as valid collateral advantages as long as these additional rights are fair and do not interfere with the borrower’s equity of redemption. Simply stated, a collateral advantage is an agreement entered into by a borrower and lender, separate from the loan agreement, giving the lender certain rights regarding the borrower’s property. For example, in Kreglinger v. New Patagonia Meat & Cold Storage Co., 1914 App.Cas. 25, 109 L.T.R. 802, the lender’s 5-year option to purchase all the sheepskins produced by the borrower’s meat-packing business at the highest price offered by anyone else was held to be an enforceable collateral advantage. The court interpreted the transaction as essentially two contemporaneous contracts — one for the loan and the other for the purchase of sheepskins. Even though the borrower would not necessarily receive his property back in the same condition after redemption if the borrower repaid the loan before the expiration of the 5-year option, the court held that the borrower’s right to redeem was not impaired and refused to invalidate the lender’s right of first refusal. Relying on Kreglinger, if the buyer-landlord structures its interest in the seller-tenant’s property as a right of first refusal instead of as an option, the right of first refusal would probably be an enforceable collateral advantage. A buyer-landlord’s option to purchase the improvements may also be upheld as a valid collateral advantage if the transaction is structured so that the option is fair and does not interfere with the seller-tenant’s equity of redemption. For example, the buyer-landlord might allow the seller-tenant to negate the option by paying a premium to the buyer-landlord. The seller-tenant would then retain its ability to redeem its property even though it would require an additional payment. Kane, p. 137, suggests these approaches but notes that the latter type of agreement calling for the payment of a premium may be unconscionable.

Finally, even if the sale-leaseback is found to be a financing device and none of the above theories is available to avoid the effects of the clogging doctrine, the doctrine may be deemed inapplicable to this type of complex business transaction between sophisticated parties. The clogging doctrine was originally established to protect unsophisticated, desperate borrowers from submitting to harsh conditions forced on them by their desperation and their inferior bargaining positions. In complex transactions between sophisticated businesspeople, one court refused to apply the clogging doctrine, and a second court refused to find an equity of redemption in a seller-tenant. In MacArthur, supra, the Florida Supreme Court refused to apply the clogging doctrine to invalidate the seller-lender’s option to repurchase the property at below fair market value. The court opined that had the seller made the loan, its repurchase option would clearly have been enforceable. The court felt that it did not make sense to invalidate the option merely because the seller accommodated the buyer by making the loan. The court considered the complex nature of the transaction, the various agreements of the parties, and the sophistication of the parties and decided that the clogging doctrine was inapplicable to this type of complex business transaction between sophisticated parties mixing elements of sale and mortgage.
In *Kassuba, supra*, the buyer-landlord purchased the land only and leased it back to the seller-tenant for a term of years. As part of the lease, the buyer-landlord granted the seller-tenant an option to repurchase the land at a set price after the fourth lease year but before the term expired. When the seller-tenant went bankrupt, he sought to defeat the buyer-landlord’s action to terminate the lease and obtain clear title to the land and improvements by alleging that the transaction was really a mortgage transaction that gave rise to an equity of redemption in the seller-tenant extinguishable only through foreclosure proceedings. The court rejected this argument; it refused to recognize an equity of redemption in the seller-tenant because the parties were sophisticated in real estate matters, were represented by counsel, and, in testimony and in the documents, admitted that they intended the transaction to be a sale-leaseback.

These two cases appear to support an argument that the clogging doctrine should not be used to invalidate complex business arrangements between sophisticated parties. *Kassuba* supports the proposition that no equitable right of redemption should arise in complex sale-leaseback arrangements between sophisticated parties. These concepts may well be applicable to support an option granted as part of a complicated sale-leaseback transaction against an attack based on the clogging doctrine.

O. Estoppel Certificates

1. [5.58] In General

Leases in sale and leaseback transactions generally contain a requirement that either party to the lease, upon the request of the other, will deliver an estoppel certificate to the requesting party setting forth basic information concerning the status of the lease. It is of vital importance to each party that it be able to obtain such an estoppel certificate. The buyer-landlord’s ability to assign its reversionary interest and mortgage the fee will very likely rest on the strength of the ground lease. The estoppel certificate that the buyer-landlord obtains from the seller-tenant will enable the buyer-landlord to demonstrate to the assignee or mortgagee that the lease is in full force and effect. Similarly, the seller-tenant may desire to assign its leasehold interest and its interest in the buildings and improvements or to mortgage these interests at some time during the lease term. Since all the seller-tenant has to sell to an assignee with regard to the land is the leasehold interest therein and all the seller-tenant has to pledge to a leasehold mortgagee is the leasehold (and since, in either case, the seller-tenant’s interest in the improvements depends on the validity of the leasehold), the seller-tenant must also be in a position to demonstrate that the lease is in full force and effect.

2. [5.59] Form of Provision for Delivery of Estoppel Certificate by Landlord and Tenant

Landlord and Tenant agree at any time and from time to time, upon not less than [10] days’ prior written request by either, to execute, acknowledge, and deliver to the other a statement in writing certifying that this Lease is unmodified and in full force and effect (or, if there have been modifications, that the Lease is in full force and effect as modified and stating the modifications), the dates to which the rental and other charges have been paid in advance, if any, and whether, to the knowledge of the party executing the certificate, there
are then any defaults under this Lease, either by Landlord or by Tenant or both (and, if so, specifying such defaults), it being intended that any such statement delivered pursuant to this article may be relied on by any prospective purchaser of the fee or leasehold or mortgagee or assignee of any mortgage on the fee or leasehold, as the case may be.

P. Maintenance, Repairs, and Alterations — Compliance with Laws

1. [5.60] In General

The seller-tenant will normally be required by the lease, at its expense, to maintain the improvements in good repair and to make any changes or alterations that may be required by law. The lease usually will also contain provisions requiring the seller-tenant to discharge all obligations relating to adjoining land, such as shoring up, keeping adjoining streets and sidewalks safe and free from obstruction, and like matters. These obligations to repair and maintain must be clearly spelled out in the lease in light of the general rule with respect to repairs that, absent any contrary lease provision,

[the relation of landlord and tenant creates no obligation or duty on the landlord to make repairs, unless he assumed such duty by express agreement with the tenant... A covenant to repair by the tenant, except to prevent waste by his acts of negligence, is not implied by law and an express covenant to repair will not be enlarged by construction. [Citation omitted.] Hollywood Building Corp. v. Greenview Amusement Co., 315 Ill.App. 658, 43 N.E.2d 566, 567 (1st Dist. 1940). Accord Ing v. Levy, 26 Ill.App.3d 889, 326 N.E.2d 51 (1st Dist. 1975).

The lease commonly used in the typical net lease situation differs in its repair provisions from that used in a sale and leaseback transaction. In the usual type of net lease, in which the tenant has not been the previous owner of the premises, provision is frequently made for the landlord to be liable for maintenance, to remedy defects appearing during the first year, and to correct violations of legal requirements that required correction when the lease began. If, however, the tenant was the former owner of the premises and has sold it to the landlord, as in a sale and leaseback, the tenant can hardly expect to look to the landlord to make good its own shortcomings. Accordingly, the lease in a sale and leaseback transaction requires the seller-tenant to assume maintenance obligations from the beginning of the lease term.

A seller-tenant may wish to place certain limitations on the lease requirement that the seller-tenant comply with all laws, ordinances, and regulations affecting the property to avoid technical default under the lease for any violation of laws that do not affect the buyer-landlord’s interest in the property. The buyer-landlord may resist such a request if the continued operation of the premises by the seller-tenant is of economic importance to the buyer-landlord. The specifics of any such limitations on the duty of the seller-tenant to comply with the applicable laws, ordinances, and regulations would have to be worked out on a case-by-case basis depending on the type of buildings and the nature of seller-tenant’s operation.

A problem arises from the seller-tenant’s point of view if, due to a change in a law near the end of the lease term, the seller-tenant is required to expend substantial sums to comply with the
change. If only a short period remains under the lease term, the buyer-landlord clearly will derive the major benefit from such improvements made by the seller-tenant. A provision should be made either for an equitable allocation of any such expenditure incurred by the seller-tenant within the last few years of the lease term or for giving the seller-tenant the right to terminate the lease rather than make the change. A provision allowing an early termination could take substantially the same form as the provision discussed earlier (see §5.35 above) giving the seller-tenant the right to terminate the lease following damage to the improvements during the final years of the lease term.

The extent to which the seller-tenant will be allowed to construct new improvements on the premises and to make alterations to existing improvements depends, in large part, on whether the lease is based on the seller-tenant’s credit. In those instances in which the lease is a credit lease and the buyer-landlord is looking more to the rent than to the specific improvements, the seller-tenant will often be given very broad power to make alterations to the improvements and to construct new improvements with, perhaps, only a requirement that, after completion of alterations, the altered or new improvements be of at least equal quality and rental value to those existing before commencement of the work. On the other hand, if the improvements are unique or if their physical value is of great importance, the seller-tenant will be much more restricted in its right to make material alterations.

The lease also should contain a provision that if the seller-tenant fails to make the required repairs or alterations, the buyer-landlord may step in and do the work itself and charge the seller-tenant for the cost of that work plus interest. In Illinois, if a tenant specifically covenants to keep the premises in good repair but fails to do so, a landlord who enters the premises and makes such a repair will be deemed to have acted as a volunteer and to have no right to recover for the cost of the repairs from the tenant, absent a specific lease requirement that the tenant pay for such repairs made by the landlord. Wicker v. Lewis, 40 Ill. 251 (1866). Similarly, a right reserved in the landlord to enter the premises to make any necessary repairs without any accompanying requirement that the tenant pay for the repairs will not obligate the tenant to pay for repairs made by the landlord. Rose v. Stoddard, 181 Ill.App. 405 (1st Dist. 1913). See generally Bennett I. Berman, The Duty of Repair and Restoration of Leased Premises in Illinois, 53 Chi.B.Rec. 373, 376 – 377 (1972). If the lease grants the landlord the right to enter into the premises and make repairs the tenant was obligated but failed to make and then to seek reimbursement from the tenant for the cost of these repairs, the landlord need not wait until the end of the lease term to recover for the cost of these repairs. Gubbins v. Glabman, 215 Ill.App. 43 (1st Dist. 1919).

The seller-tenant may object to a provision allowing the buyer-landlord to make repairs on behalf of the seller-tenant because a dispute may arise between the seller-tenant and the buyer-landlord as to the necessity of any repair and because the buyer-landlord could expend more money on repairs than the seller-tenant would deem necessary. Questions concerning the necessity of any repair and the reasonableness of the cost incurred by the buyer-landlord in making that repair are ideal issues to be determined by arbitration. See §5.67 below. Having these questions resolved by arbitration should help relieve the seller-tenant’s anxiety. At a minimum, the seller-tenant should agree to a provision allowing the buyer-landlord to make repairs in an emergency situation.
The buyer-landlord will want to make certain that all repairs, improvements, or alterations to the buildings and improvements to the demised premises generally will be paid for so no mechanics liens will be filed against the property. This can be evidenced by delivery by the seller-tenant to the buyer-landlord of appropriate contractors' affidavits and lien waivers. In addition, before the work commences, the buyer-landlord may also want the seller-tenant to provide some kind of bond to be certain that this work will be paid for.

The lease provision should be carefully coordinated with any mortgage since most mortgages contain provisions with regard to alterations in the mortgaged premises.

2. Forms

a. [5.61] Provision Governing Tenant's Obligation To Maintain Premises

Tenant has inspected the Demised Premises, finds them to be in safe and satisfactory condition, and acknowledges that Landlord has made no representation to Tenant as to the condition, safety, fitness for use, or state of repair of the Demised Premises. Landlord covenants and agrees that it will not use or permit any person to use the Demised Premises and all buildings and improvements thereon or any part thereof for any use or purposes in violation of the laws of the United States or the state in which the Demised Premises are located or of the ordinances or other regulations of the municipality or political subdivision in which the Demised Premises are located or of any other lawful authority; that during the term of the Lease it will keep the Demised Premises and all buildings and improvements thereon in a clean and wholesome condition and good state of repair and generally that it will in all respects and at all times fully comply with all lawful health and police regulations; that it will keep the Demised Premises and all buildings and improvements thereon and all sidewalks and areas adjacent thereto, as well as in the area thereof, safe, secure, and conformed to the lawful and valid requirements of any municipality or political subdivision in which the Demised Premises may be situated and of all other public authorities, and will make at its own expense all improvements, alterations, and repairs on the Demised Premises and all buildings and improvements thereon and to the appurtenances and equipment thereof required by any lawful authorities or that may be made necessary by the act or neglect of any other person or corporation (public or private), including supporting the streets and alleys adjoining the Demised Premises and shoring up and protecting any of the buildings and improvements thereon or strengthening the foundations of any building at any time situated on the Demised Premises.

b. [5.62] Provision Giving Tenant Right To Make Alterations

1. Tenant shall have, at its own expense and subject to the conditions of this Lease, the right at any time and from time to time during the term of this Lease to make such changes and alterations, structural or otherwise, to the buildings and improvements on the Demised Premises and to erect, place, or install on the Demised Premises buildings, structures, improvements, and equipment in addition to or in substitution for those now or after this date located thereon and to remove any building or buildings, improvements, or equipment
now or after this date located on the Demised Premises upon making any replacements or substitutions therefor as Tenant may deem necessary or desirable, it being agreed that the salvage from replacements or substitutions shall become the property of Tenant and may be disposed of in any manner as Tenant may deem best.

2. Anything contained in this Lease to the contrary notwithstanding, Tenant shall not remove or alter any building or buildings, improvements, or equipment now or after this date located on the Demised Premises unless the new or altered building or buildings, improvements, or equipment, as the case may be, shall have a fair value and rental value at least equal to that of the building or buildings, improvements, or equipment so removed or altered. Tenant shall forthwith, after any removal, erect, construct, complete, and pay for any new building or buildings, improvements, or equipment, as the case may be. Tenant shall not make or suffer or permit any subtenant to make any structural change or alteration or any removal and replacement of any construction or alteration or construct any additional improvements involving a reasonably estimated cost of more than $_______ unless before any work shall have been commenced, (a) plans and specifications for this work prepared by a reputable licensed architect shall have been submitted to and approved by Landlord, which approval shall not be unreasonably withheld or delayed; (b) Tenant shall have furnished to Landlord an estimate of the cost of the proposed work, certified to by the architect by whom such plans and specifications shall have been prepared; and (c) Tenant shall either have furnished to Landlord (i) a bond on which Tenant shall be principal and on which a surety company, authorized to do business in the state in which the Demised Premises are situated and satisfactory to Landlord, shall be surety, and which bond shall be in form satisfactory to Landlord and shall be conditioned on the completion of and payment in full for all work within a reasonable time, subject, however, to delays occasioned by strikes, lockouts, acts of God, governmental restrictions, or similar causes beyond the control of Tenant; or (ii) other security satisfactory to Landlord to ensure payment for and completion of all work, free and clear of liens.

c. [5.63] Provision with Respect to Liens Created or Caused To Be Created by Tenant

Nothing in this Lease contained shall authorize Tenant to do any act that shall in any way encumber Landlord’s title in and to the Demised Premises, nor shall the interest or estate of Landlord in the Demised Premises be in any way subject to any claim by way of lien or encumbrance, whether by operation of law or by virtue of any express or implied contract by Tenant, and any claim to or lien on the Demised Premises arising from any act or omission of Tenant shall accrue only against the leasehold estate of Tenant and Tenant’s interest in the buildings and improvements situated on the Demised Premises and shall in all respects be subject and subordinate to the paramount title and right of Landlord in and to the Demised Premises and Landlord’s reversionary interest in the buildings and improvements.

Tenant shall not permit the Demised Premises or buildings and improvements to become subject to any mechanics, laborer’s, or material supplier’s lien on account of labor or material furnished to Tenant or any subtenant in connection with work of any character
performed or claimed to have been performed on the Demised Premises or in the buildings and improvements by or at the direction or sufferance of Tenant; provided, however, that Tenant shall have the right to contest in good faith and with reasonable diligence the validity of any lien or claimed lien if Tenant shall give to Landlord any reasonable security as may be demanded by Landlord to ensure payment and to prevent any sale, foreclosure, or forfeiture of the Demised Premises by reason of nonpayment thereof. Upon final determination of the lien or claim for lien, Tenant will immediately pay any judgment rendered with all proper costs and charges and will at its own expense have the lien released and any judgment satisfied. If Tenant pays any judgment rendered together with costs and charges and secures release of the lien and satisfaction of any judgment and if Tenant is not in default under the provisions of this Lease, Landlord shall return to Tenant the cash and securities deposited by Tenant pursuant to this article. In the alternative, if requested by Tenant, Landlord shall use any cash or the proceeds of any securities deposited by Tenant with Landlord, less the amount of any loss, cost, damage, and reasonable expense that Landlord may sustain in connection with the lien so contested, to pay the amount necessary to discharge any lien or judgment by liquidating any securities in the manner directed by and at the expense of Tenant and delivering to Tenant checks payable to the lienor.

If Tenant shall fail to contest the validity of any lien or claim for lien and give security to Landlord to insure payment thereof or, having commenced to contest the lien or claim and having given such security, shall fail to prosecute such contest with diligence or shall fail to have the lien released and satisfy any judgment rendered thereon or to request Landlord to do so using the cash or securities deposited by Tenant during the pendency of this contest, as provided above, or, if Tenant shall be in default under any provision of this Lease, then Landlord may, at its election (but shall not be required so to do), remove or discharge any lien or claim for lien (with the right in its discretion to settle or compromise the lien or claim) using the cash or securities deposited by Tenant for these purposes (including the payment of any costs incurred by Landlord in so doing) or may use any deposited cash or other securities to cure Tenant's other default under this Lease. Any amounts advanced by Landlord to remove or discharge any lien or claim for lien in excess of any cash or the proceeds of the securities deposited with Landlord during this contest shall be so much Additional Rental due from Tenant to Landlord at the rate of ______ percent per annum from the date of payment thereof by Landlord until the repayment thereof by Tenant to Landlord.

Q. Tenant’s Payment of Taxes and Other Impositions

1. [5.64] Customary Requirements

The lease will invariably include a provision requiring the seller-tenant to pay all taxes, special assessments, and other governmental impositions levied on the land and improvements.

The seller-tenant will agree to pay all taxes that have already accrued but are unpaid at the commencement of the term of the lease, there having been no allowance for these taxes in favor of the buyer-landlord in the prorations at the closing of the sale that preceded the lease. There will
also be a provision to prorate the taxes for the last year of the lease term and a provision allowing the seller-tenant to protest or contest taxes, with all benefits going to the seller-tenant, as long as adequate security is posted by the seller-tenant to assure payment, after any contest terminates, of any contested tax or imposition plus all interest and penalties.

2. Forms

a. [5.65] Provision for Tenant's Undertaking To Pay Taxes, Etc.

1. Tenant shall pay as Additional Rental for the Demised Premises (and shall furnish Landlord with receipts for these payments within [30] days after payment) all taxes and assessments, general and special, water and sewer charges, and all other impositions, ordinary and extraordinary, of every kind and nature whatsoever, that may be levied, assessed, or imposed on the Demised Premises or any part thereof, or on any buildings or improvement at any time situated thereon, becoming due and payable during the term of this Lease (including any levied or assessed on Landlord's interest under this Lease), together with all unpaid installments of special assessments levied against the Demised Premises for improvements completed or not yet completed, whether now accrued or becoming due and payable during the term of this Lease, all of which taxes, assessments, charges, and other impositions (Impositions) shall be paid by Tenant before they shall respectively become delinquent and in any case within a period of time as to prevent any sale or forfeiture therefor of the Demised Premises and the buildings and improvements situated thereon or any part thereof; provided, however, that the liability of Tenant with respect to special assessments shall be limited to the payment of any installments that mature during the term of this Lease, including the term of any renewals, together with interest thereon, and that any Impositions levied for the last calendar year of the original term, or any renewal term, shall be prorated between Landlord and Tenant on and as of the date of the expiration of the term hereof on the basis of the then last available tax bills.

2. Nothing contained in this Lease shall be construed to require Tenant to pay any franchise, inheritance, estate, succession, or transfer tax of Landlord or any income or excess profits tax assessed on or in respect of the income of Landlord or chargeable to or required to be paid by Landlord unless this tax shall be specifically levied against the income of Landlord derived from the rent by this Lease reserved, expressly and for a specific substitute for the taxes, in whole or in part, on the Demised Premises, the buildings and improvements thereon, or any part thereof, all of which taxes so specifically levied Tenant covenants and agrees to pay as so much Additional Rental as and when they become due and payable; provided, however, that if the amount or rate of any income or excess profit taxes so levied against the income of Landlord, as a specific substitute for the taxes on the Demised Premises and/or buildings and improvements thereon or any part thereof, shall be increased by reason of any other income received or property owned by Landlord, then Tenant shall not be obligated to pay an increased amount but only that tax that Landlord would be obligated to pay in case it derived no income from any source other than the real estate hereby demised.
b. [5.66] Provision for Landlord's Right To Pay Delinquent Impositions

Landlord shall, at its option, have the right at all times during the term of this Lease to pay any Imposition remaining unpaid after it shall have become delinquent and to pay, cancel, and discharge tax sales, liens, and claims against the Demised Premises and the buildings and improvements situated on the Demised Premises and to redeem the Demised Premises, buildings, and improvements from them or any of them from time to time; and the amount so paid, including all expenses incurred, shall be so much Additional Rental due from Tenant to Landlord on the rent day after any payment, with interest at the rate of _____ percent per annum from the date of payment thereof by Landlord until the repayment thereof by Tenant to Landlord.

c. [5.67] Provision for Tenant's Right To Contest Impositions

1. Any other provision of this Lease to the contrary notwithstanding, Tenant shall not be required to pay or discharge any Imposition as long as Tenant shall in good faith and with due diligence contest it by appropriate legal proceedings that shall have the effect of preventing the collection of the Imposition so contested and the sale or forfeiture of the Demised Premises or any part thereof or any building or improvements thereon and provided that, pending any such legal proceedings, Tenant shall deposit with Landlord cash or securities satisfactory to Landlord in an amount satisfactory to Landlord to assure payment of the Imposition so contested and all interest and penalties thereon. Landlord shall not be obligated to pay Tenant any interest on any cash deposited by Tenant with Landlord pursuant thereto.

2. During compliance with the procedure set forth in Paragraph 1, Landlord shall not have the right to pay or discharge the Imposition so contested. At the conclusion of this contest, upon written request of Tenant accompanied by the bill for the Imposition then due, Landlord shall use the cash or securities so deposited, less the amount of any loss, cost, damage, and reasonable expense that Landlord may sustain in connection with the Imposition so contested, to pay this Imposition by liquidating any securities in the manner directed by and at the expense of Tenant and delivering to Tenant checks or other vouchers payable to the proper tax authority; or if the Demised Premises and buildings and improvements thereon shall have been released and discharged from any Imposition and if Tenant is not in default under the provisions of this Lease, Landlord shall return the cash or securities so deposited to Tenant; provided, however, that if Tenant fails to prosecute this contest with due diligence or fails to maintain said deposit as above provided or if Tenant is otherwise in default under the provisions of this Lease or if, at the conclusion of this contest, Tenant fails to request Landlord to pay the Imposition, Landlord may use the cash or securities so deposited to pay any item for which Landlord would be entitled to make advances under this Lease. The amount of any money deposited by Tenant or the face amount of any bond posted by Tenant with any municipality or other governmental body to secure the payment of any Imposition in connection with any contest thereof shall be credited upon the deposit required in this paragraph to be made by Tenant with Landlord, provided that such bond shall have been approved by Landlord.
(3) In the event that Tenant at any time institutes suit to recover any Imposition paid by Tenant under protest, Tenant shall have the right, at its sole expense, to institute and prosecute any suit or suits in Landlord’s name, in which event, Tenant covenants and agrees to indemnify Landlord and save it harmless from and against all costs, charges, or liability in connection with any suit. All funds recovered as a result of any suit shall belong to Tenant.

R. Remedies upon Default — Arbitration

1. [5.68] In General

Credit tenants frequently include a provision in their leases permitting them to cure a landlord’s defaults and withhold rent to offset any sums advanced. Such a provision should not have application in a sale-leaseback context, however, since the buyer-landlord has no affirmative covenants. One exception, however, may exist if the buyer-landlord has mortgaged the fee and the seller-tenant’s leasehold rights are subject to the fee mortgage.

Absent a provision allowing a tenant to cure its landlord’s default, Illinois courts have held that in a commercial lease situation, the tenant cannot withhold rent by reason of the landlord’s default since the landlord’s obligations under the lease and the tenant’s obligations to pay the rent are independent covenants. *Truman v. Rodesch*, 168 Ill.App. 304 (2d Dist. 1912). The one established exception occurs when the landlord’s default constitutes a constructive eviction, and the tenant, within a reasonable time after the breach occurs, terminates the lease and vacates the premises; in this case, the tenant’s liability for rent ceases when it terminates the lease and vacates the premises. *John Munic Meat Co. v. H. Gartenberg & Co.*, 51 Ill.App.3d 413, 366 N.E.2d 617, 9 Ill.Dec. 360 (1st Dist. 1977); *Book Production Industries, Inc. v. Blue Star Auto Stores, Inc.*, 33 Ill.App.2d 22, 178 N.E.2d 881 (2d Dist. 1961); *Applegate v. Inland Real Estate Corp.*, 109 Ill.App.3d 986, 441 N.E.2d 379, 65 Ill.Dec. 466 (2d Dist. 1982); *C.F. Birtman Co. v. Thompson*, 136 Ill.App. 621 (1st Dist. 1907); David Levinson, *Basic Principles of Real Estate Leases*, 1952 U.Ill.L.R. 321, 326. While Illinois courts seem to have begun to move away from the absolute doctrine of independent covenants in residential leases (*Jack Spring, Inc. v. Little*, 50 Ill.2d 351, 280 N.E.2d 208 (1972); *Pole Realty Co. v. Sorrells*, 78 Ill.App.3d 361, 397 N.E.2d 539, 34 Ill.Dec. 83 (1st Dist. 1979), rev’d in part, 84 Ill.2d 178 (1981)), Illinois courts have expressly determined that the *Jack Spring* reasoning should not be extended to commercial leases (*General Parking Corp. v. Kimmel*, 79 Ill.App.3d 883, 398 N.E.2d 1104, 35 Ill.Dec. 154 (1st Dist. 1979); *Elizondo v. Perez*, 42 Ill.App.3d 313, 356 N.E.2d 112, 1 Ill.Dec. 112 (1st Dist. 1976); *Ing v. Levy*, 26 Ill.App.3d 889, 326 N.E.2d 51 (1st Dist. 1975)). But see *Book Production Industries, supra*.

If the buyer-landlord has mortgaged the fee on the basis of a credit lease, the fee mortgagee may take exception to the seller-tenant’s right to withhold rent since this jeopardizes part of the mortgagee’s security. The mortgagee may insist that, at a minimum, the seller-tenant notify the mortgagee of a default by the buyer-landlord giving rise to a right to withhold rent and give the mortgagee a suitable time to foreclose the mortgage and cure.
The buyer-landlord's remedies will usually include the standard remedy of termination. An additional provision is often made for the seller-tenant's liability to survive a termination of the lease resulting from seller-tenant's default. This result can be accomplished by providing that, notwithstanding termination of the lease, the seller-tenant remains liable for damages, payable each month, based on the excess of the monthly rent, taxes, and other carrying costs of the property paid by the buyer-landlord over the amount, if any, of the net rent received from reletting the premises. The lease may also provide for the seller-tenant to pay damages in a lump sum equal to the differences between the then-present value of the rent reserved under the lease and the rental value of the premises for the remainder of the term, notwithstanding termination of the lease. The best practice is to give the buyer-landlord an election to choose either of these alternatives so that, in the event of the seller-tenant's default, the buyer-landlord can choose the most favorable one under the particular circumstances.

Unless the lease grants the buyer-landlord the right to lump-sum damages, the lump-sum damages option is not available to it under Illinois law. 735 ILCS 5/9-201, et seq. If there is no provision in the lease giving the buyer-landlord the right either to terminate the lease and collect damages or terminate the right of possession without terminating the lease, the buyer-landlord must elect whether to keep the lease in force with the seller-tenant remaining in possession and sue for the rent each month or to terminate the lease and thereby release the seller-tenant from any liability for rent that has not accrued at the date of termination. Id.

In order to avoid releasing the seller-tenant from liability upon termination of the lease for default, an additional precaution is sometimes taken to give the buyer-landlord the election to terminate the seller-tenant's right of possession without terminating the lease. However, if, as stated above, proper provision is made for payment of damages, the termination of the lease will not release the seller-tenant from liability for damages resulting from the termination of the lease.

"Ipso facto" provisions in leases making an act of bankruptcy under the federal law an event of default under a lease have been rendered invalid by the Bankruptcy Code. 11 U.S.C. §365(e). See §5.7 above.

Since the seller-tenant's interest in a sale-leaseback transaction often represents a substantial investment in buildings and improvements, it will want to be protected from having the lease terminated by reason of a default arising from a legitimate dispute between the seller-tenant and the buyer-landlord. The seller-tenant may request an arbitration provision in the lease covering all nonpayment defaults. If the buyer-landlord agrees to such an arbitration provision, it will want to ensure that the arbitrator's decision was made promptly so that if, for example, the disputed default involves the necessity of making certain repairs orremedyng certain violations of law, the dispute will be resolved without further deterioration of the property. In fact, even if there is an arbitration provision, the buyer-landlord may still wish to retain the right to perform the disputed obligation before the decision is made by the arbitrator, with the effect that if the arbitrator finds in the buyer-landlord's favor, the seller-tenant will be required to reimburse the buyer-landlord for the cost of such performance in addition to possibly having the lease terminated. In addition, since arbitration may be appropriate with regard to certain factual disputes that arise under the terms of the lease but may not be desirable as a general means of resolving all disputes under the lease, the buyer-landlord may well wish to restrict arbitration to specific questions of fact.
At times, seller-tenants request a lease provision that in the event the net return to the buyer-landlord from reletting the premises following the seller-tenant’s default exceeds the net return that would have been payable to the buyer-landlord under the defaulted lease, the defaulting seller-tenant be entitled to the excess. Such a provision is usually inappropriate since it allows a defaulting seller-tenant to profit from the default. Giving the seller-tenant the right to any excess encourages a default by a seller-tenant, especially one whose right to assign its lease interest is restricted, if market conditions are such that the buyer-landlord will most likely find a successor tenant who will pay a higher rental.

In certain situations, especially when the buyer-landlord has entered into the sale and leaseback transaction in reliance on the value of the improvements and not on the credit of the seller-tenant, the seller-tenant may wish to limit liability in the event of default to the buyer-landlord’s right to regain possession of the premises. In Illinois, one way by which this can be accomplished is by creating a land trust, the sole assets of which are the leasehold estate and the tenant’s interest in the buildings and improvements, to serve as the seller-tenant. This may require certain modifications to the land trust agreement commonly used by land trustees in the Chicago metropolitan area to allow the land trustee to hold a leasehold interest. If the land trust device is not available because the property is situated outside Illinois or because of tax considerations, the same effect can be accomplished by adding appropriate exculpatory language to the lease.

The buyer-landlord may also wish to limit liability under the lease to the period during which it is the landlord under the lease. From and after the transfer, the buyer-landlord will be relieved of any further liability under the lease as long as it has delivered to the successor landlord all funds of the seller-tenant that the assigning landlord is then holding.

2. Forms

a. [5.69] Provision for Damages by Reason of Termination of Lease Resulting from Tenant’s Default

1. The foregoing provision for the termination of this Lease for any default in any of Tenant’s covenants shall not operate to exclude or suspend any other remedy of Landlord for breach of any of the covenants or for the recovery of the rent or of any advance of Landlord made thereon. In the event of the termination of this Lease as stated above, Tenant covenants and agrees to indemnify and save harmless Landlord from any loss arising from this termination and reentry in pursuance thereof, and to that end, Tenant covenants and agrees to pay to Landlord after this termination and reentry, at the end of each month of the demised term, the difference between the net income actually received by Landlord from the Demised Premises during this month and the rent, Impositions, and other sums that Tenant has agreed to pay by the terms of this Lease during this month, but that Landlord has paid, together with Landlord’s expenses of reletting and altering the improvements on the Demised Premises and together with all commissions and attorneys’ fees and expenses incurred in connection therewith.

2. In lieu of the remedy for damages provided in the previous paragraph, Landlord may elect to recover against Tenant, as damages for loss of the bargain and not as a penalty,
and Tenant at the time of this termination shall be liable for and shall pay to Landlord, on demand, an amount equal to the excess, if any, of the present value of the Basic Rent that may be payable under this Lease from the date of demand until the end of what would have been the term of this Lease had it not been terminated by reason of default (including any renewals or extensions resulting from any options that Tenant may have exercised) over the present value of the then fair rental value of the Demised Premises for the same period. Election may be made at any time after termination of this Lease and shall not affect Landlord’s right to receive current damages, as provided above, that may have accrued prior to the date of demand.

b. [5.70] Provision Limiting Tenant’s Liability to Leasehold Estate and Buildings and Improvements When Tenant Is Not Land Trustee

Notwithstanding that all of the covenants, agreements, conditions, and undertakings herein are in substance and in form expressed in language creating personal covenants on the part of Tenant, the liability of Tenant, its [partners, officers, directors, shareholders, and employees], and Tenant’s successors or assigns with respect to all covenants, agreements, conditions, and undertakings herein shall be limited to and shall not extend beyond Tenant’s leasehold estate hereby created and Tenant’s rights in the buildings and improvements. No personal liability shall be asserted or be enforceable against Tenant, its [partners, officers, directors, shareholders, or employees], or Tenant’s successors or assigns to enforce or assert any personal obligation or liability hereunder. The parties hereto intend that the sole remedy of Landlord in enforcing Tenant's liability hereunder and all of the terms, covenants, conditions, and undertakings in this Lease contained shall be limited to Tenant’s leasehold estate and interest in the buildings and improvements. This provision shall supersede any other provisions of this Lease inconsistent or apparently inconsistent herewith.

c. [5.71] Provision Limiting Landlord’s Liability to Period Before Assignment to Successor of Landlord’s Interest Under Lease

“Landlord,” as far as covenants or obligations on the part of Landlord are concerned, shall be limited to mean only the owner or owners of the fee of the Demised Premises at the time in question and, in the event of any transfer or transfers of the title to this fee, the Landlord herein named (and in case of any subsequent transfers or conveyances, the then-grantor) shall be automatically freed and relieved, from and after the date of the transfer or conveyance, of all personal liability as respects the performance of any covenants or obligations on the part of Landlord contained in this Lease thereafter to be performed; provided that any funds in the hands of Landlord or the then grantor at the time of the transfer in which Tenant has an interest shall be turned over to the grantee, and any amount then due and payable to Tenant by Landlord or the then grantor under any provisions of this Lease shall be paid to Tenant.

See §5.68 above for an extensive discussion of rights and remedies upon default.
V. THE RISK OF RECHARACTERIZATION IN BANKRUPTCY
PROCEEDINGS

A. [5.72] In General

Federal tax cases have looked to the economic substance of a transaction to determine whether a true sale and leaseback was created for tax purposes. See Frank Lyon Co. v. United States, 435 U.S. 561, 55 L.Ed.2d 550, 98 S.Ct. 1291 (1978). Some courts in federal bankruptcy proceedings have adopted this analysis and focused on the economic substance of the transaction, not on the formal characterization the parties placed on the arrangement. Courts finding that the economic substance of a sale and leaseback does not support the format the parties assigned to it have recharacterized the transaction as either a joint venture or a disguised loan (with the buyer-landlord’s rights in the property perhaps constituting an equitable mortgage). Other bankruptcy courts viewing similar fact situations have deferred to the negotiating terms and conditions established in the governing documents and have upheld the sale and leaseback structure.

Before reviewing several of these cases, it is necessary to consider pertinent provisions of the Bankruptcy Code and the treatment of leases, loans, and joint ventures to understand the treatment of leases in bankruptcy and the effect of sale and leaseback transactions being recharacterized as equitable mortgages or joint ventures under the Code. Because every principal case involving recharacterization of a sale and leaseback involves a bankrupt seller-tenant, this discussion focuses on the treatment of bankrupt seller-tenants rather than bankrupt buyer-landlords.

B. [5.73] The Bankruptcy Code

Commercial leases typically provide that the lessee’s filing of a petition in bankruptcy or the appointment of a receiver or bankruptcy trustee constitutes an event of default, allowing the lessor to terminate the lease or triggering an automatic termination of the lease. In addition, the lessee’s right to assign the lease or sublet the leased premises is often prohibited or subjected to the lessor’s consent. Section 70(b) of the Bankruptcy Act of 1898 expressly permitted landlords to enforce lease provisions authorizing termination of the lease in the event of the lessee’s bankruptcy. Thus, the Bankruptcy Act of 1898 severely limited the bankrupt lessee’s ability to retain its lease or to sell the leasehold estate and use the proceeds to pay creditors. In a number of cases arising under the Bankruptcy Act of 1898, however, bankruptcy courts invoked their equitable powers to deny enforcement of such ipso facto termination provisions. See, e.g., In re Queens Boulevard Wine & Liquor Corp., 503 F.2d 202 (2d Cir. 1974); Weaver v. Hutson, 459 F.2d 741 (4th Cir. 1972); In re Fleetwood Motel Corp., 335 F.2d 857 (3d Cir. 1964). In the landmark Queens Boulevard decision, 503 F.2d at 206 – 207, the court, balancing the interests of the lessor, the bankrupt lessee, and its creditors, held that the termination provision was unenforceable. The 1978 Bankruptcy Code repealed the Bankruptcy Act of 1898 and incorporated the Queens Boulevard rule into a complex statutory scheme governing leases in bankruptcy proceedings. 11 U.S.C. §365. In addition, the Bankruptcy Code severely limited the effect of lease provisions prohibiting or restricting assignments of leases by lessees.
C. [5.74] Leases in Bankruptcy

The treatment of leases under the Bankruptcy Code differs dramatically from the treatment of loans and joint ventures under the Bankruptcy Code. Under §362(a), a debtor’s filing of a petition in bankruptcy automatically stays any action to enforce a judgment obtained against the debtor prior to the filing of the petition. 11 U.S.C. §362(a). This automatic stay provision precludes a lessor from recovering possession of the leased premises or from obtaining satisfaction of a monetary award granted in a forcible entry and detainer action against a defaulting lessee. If a lease terminates at the expiration of its natural term, the automatic stay does not prohibit the lessor from recovering possession of the leased premises. Otherwise, unless the Bankruptcy Court grants the lessor relief under §362(d), the automatic stay suspends the lessor’s right to enforce non-bankruptcy remedies against the lessee until conclusion of the bankruptcy proceedings or natural expiration of the lease. If the bankruptcy proceedings end first, the lessee will probably receive a discharge under §727, giving the lessee a fresh start and preventing the lessor from enforcing non-bankruptcy remedies against the lessee. Thus, a lessor typically is left to pursue only those remedies granted under the Bankruptcy Code.

The lessor’s principal remedy against a lessee in a bankruptcy proceeding is to compel a prompt assumption or rejection of the lease pursuant to §365(d), which allows the trustee “an opportunity to determine which of the bankrupt’s contracts are beneficial to the estate and on that basis make an election whether to assume or to reject them.” In re SteelShip Corp., 576 F.2d 128, 132 (8th Cir. 1978). Courts apply a business-judgment test to determine “whether the decision of the debtor that rejection will be advantageous is so manifestly unreasonable that it could not be based on sound business judgment, but only on bad faith, or whim or caprice.” Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 1047 (4th Cir. 1985). Like the business-judgment rule of corporate governance, the business-judgment test in bankruptcy operates as a presumption that the decision of a trustee (here to accept or reject a lease) was made in good faith. The Bankruptcy Code prohibits the trustee from assuming a lease, however, if the lease “has been terminated under applicable nonbankruptcy law prior to the order for relief.” 11 U.S.C. §365(e)(3). This provision is consistent with the well-established rule that the “rights of parties to real estate leases are governed by state law unless there are contrary provisions in the Bankruptcy Code.” Waldschmidt v. Appleton Investment Co. (In re Zienel Furniture, Inc.), 13 B.R. 264, 265 (Bankr. E.D.Wis. 1981).

Under §365(d)(3), the trustee has a 60-day election period to assume or reject the lease. During this period, the trustee must timely perform all obligations of the debtor that fall due subsequent to the filing of the bankruptcy petition. If the trustee determines that a lease is of benefit to the estate, the trustee has 60 days from the date of the filing of the petition to assume the lease. If the trustee fails to timely assume the lease (and does not apply for and obtain an extension of the 60-day period), §365(d)(4) deems the lease rejected and requires surrender of the property to the lessor.

If the trustee elects to assume the lease, it must cure all existing defaults under the lease (or provide adequate assurance that it will), compensate the lessor for actual pecuniary losses arising out of the defaults (or provide adequate assurance that it will), and provide adequate assurance of future performance under the lease. 11 U.S.C. §365(b)(1). The requirement to cure defaults (or
provide adequate assurances) does not apply to defaults relating to the bankruptcy of the debtor, the commencement of the bankruptcy proceedings, or the appointment of a bankruptcy trustee. 11 U.S.C. §365(b)(2). Similarly, the lease may not be terminated or modified at any time after the filing of the petition solely because of provisions in the lease conditioned on the bankruptcy of the debtor, the commencement of the bankruptcy proceedings, or the appointment of a bankruptcy trustee. 11 U.S.C. §365(e).

If the lease is assumed, it must be without modification. Once assumed, the lease may be retained by the bankrupt lessee or assigned to a new lessee, despite any provision in the lease that "prohibits, restricts, or conditions" assignment of the lease if the assignee provides adequate assurance of future performance. 11 U.S.C. §§365(f)(1), 365(f)(2). An assignment relieves the bankrupt lessee from defaults occurring subsequent to the assignment, and proceeds from assignment of the lease become property of the bankrupt estate, available to pay creditors. If the trustee elects to assume and retain the lease, however, all rents and charges that accrue after filing the petition become an administrative charge against the bankrupt estate, entitled to priority against all other unsecured claims. 11 U.S.C. §507(a)(1). Thus, although the Bankruptcy Code provides numerous protections for a bankrupt lessee, the assumption of a lease can create a significant burden on the bankrupt estate.

If the trustee rejects the lease, the lessee must surrender the leased premises, and all of the lessee’s obligations for future performance are terminated. However, all rent and charges that accrue between filing the petition in bankruptcy and rejection of the lease are administrative expenses with priority over unsecured claims. Id. Finally, rejection constitutes a default under the lease, which entitles the lessor to claim damages as a general unsecured creditor, limited to the greater of one year’s rent or 15 percent of the rent for the shorter of the remaining term of the lease or three years. 11 U.S.C. §502(b)(6). In addition, security deposits held by the lessor to secure the lessee’s performance may be set off against prepetition rents not paid by the lessee. 11 U.S.C. §553.

D. [5.75] Loans in Bankruptcy

Notwithstanding similarities in the treatment of a lease and a loan in bankruptcy, if a sale and leaseback is recharacterized as a loan, the treatment of the transaction under the Bankruptcy Code differs significantly from the treatment of a lease. Two similarities in the treatment of a lease and a loan are that the filing of a petition in bankruptcy automatically stays any action by a lender to enforce a non-bankruptcy remedy, and that the debtor’s discharge prevents a lender from enforcing non-bankruptcy remedies against the debtor after the bankruptcy case is closed. Accordingly, lenders and lessors alike must seek to enforce their claims under the Bankruptcy Code in the case of a bankruptcy. Nevertheless, although a lessor must file a claim against the bankrupt estate for prepetition unpaid rent, a lender’s remedies are more complicated.

To recover against a bankrupt debtor, a lender must file a claim against the bankrupt estate as an unsecured or a secured claimant for the total amount due. 11 U.S.C. §§501 – 510. Secured claimants usually enjoy priority over unsecured claimants with respect to receiving property or proceeds out of the bankrupt estate. 11 U.S.C. §507. Typically, unsecured claimants receive a share of the net proceeds from liquidation of the bankrupt estate or from amounts available for
unsecured creditors in a plan or arrangement in a reorganization proceeding. Secured claimants either recover their collateral or receive payment equal to the value of their collateral. 11 U.S.C. §361. Unsecured claimants simply file their claims against the bankrupt estate and, unless their claims are contested, wait to receive their share of net proceeds upon liquidation. Secured claimants also file claims against the bankrupt estate, but their secured status is subject to certain limitations.

During the post-petition administrative period, a secured lender is entitled to adequate protection of its interest in the property under §363 of the Bankruptcy Code, including post-petition debt service if the court finds that the value of the collateral exceeds the amount of the debt. Also, a debtor may abandon the collateral for a secured loan under §554(a) if it is burdensome or of inconsequential value (abandonment removes the property from the bankruptcy administration).

Unlike the provisions applicable to a lease, which require the debtor to assume or reject the lease without modification, under certain circumstances the Bankruptcy Code allows a debtor to “impair” or “modify” the terms of a secured loan without the consent of the secured lender. Also, a secured lender’s claim in bankruptcy may be deemed partially secured (because a secured claim is limited to the value of the collateral) and partially unsecured (to the extent the claim exceeds the value of the collateral). Thus, if the secured lender is under-collateralized, the lender’s secured claim will be limited to the value of the collateral, and the balance of its claim will be deemed unsecured. If entitled to do so in the loan documents, an over-collateralized lender may claim post-petition interest, attorneys’ fees, and costs of collection, but only to the extent the value of the collateral exceeds the amount of the secured claim. 11 U.S.C. §506(b).

The “strong-arm” power of the bankruptcy trustee may be used to void a secured lender’s lien or require a secured lender to return money or other property transferred to it by the debtor. The bankruptcy trustee is empowered to invalidate any transfer that is voidable under non-bankruptcy law as to a creditor who extended credit and obtained a lien on the date of the filing of the petition in bankruptcy or is voidable as to a bona fide purchaser of real property, whether such a creditor or purchaser actually exists. 11 U.S.C. §544. Lien invalidation converts a secured claim into an unsecured claim. Id. Thus, if a transfer of property from the bankrupt grantor is recorded after the date on which the bankruptcy petition is filed, the transfer may be subject to invalidation by the trustee. Also, if the transfer of property by the bankrupt grantor prior to the filing of the bankruptcy petition is deemed to be a fraudulent conveyance, the trustee is empowered to invalidate the transfer. Finally, under certain circumstances the trustee can avoid transfers of property or payments of debt by the bankrupt grantor after the filing of a bankruptcy petition and can recover the property. Thus, numerous provisions of the Bankruptcy Code may reduce the secured lender’s status in a bankruptcy proceeding to that of an unsecured claimant.

E. [5.76] Joint Ventures in Bankruptcy

A court may recharacterize a sale and leaseback transaction as a joint venture between the seller-tenant and the buyer-landlord. A joint venture is an association of two or more persons to carry out a single business enterprise for profit. Chisholm v. Gilmer, 81 F.2d 120, 124 (4th Cir.), aff’d, 57 S.Ct. 65 (1936). Like partners, joint venturers are jointly and severally liable to third
parties for the debts of the joint venture, but the liability of one joint venturer to account to another joint venturer is limited to a proportionate share of liability under the terms of the joint venture agreement and is not a several liability. *Reilly v. Freeman*, 1 A.D. 650, 37 N.Y.S. 570 (1896). If a joint venturer fails to perform obligations under the joint venture agreement, the other joint venturers may sue the defaulting joint venturer for contribution or damages. Upon dissolution of a joint venture, a joint venturer may commence an equitable action for an accounting against the other joint venturers to recover a share of the profits or to fix liability for losses. *Dickson v. Patterson*, 160 U.S. 584, 40 L.Ed. 543, 16 S.Ct. 373 (1896). Because every case in which courts have recharacterized sale and leasebacks as joint ventures involved a bankrupt lessee rather than a bankrupt joint venture entity, this discussion focuses only on the situation in which a joint venturer is bankrupt.

Upon filing a petition in bankruptcy, a joint venturer is entitled to the protection of the automatic stay provision, which precludes enforcement of non-bankruptcy remedies against the bankrupt joint venturer until termination of the bankruptcy case. Because the bankrupt joint venturer likely also will receive a discharge at the end of the bankruptcy proceeding, which prevents enforcement of non-bankruptcy remedies against the joint venturers, creditors must pursue remedies granted to them under the Bankruptcy Code. For example, a creditor of a bankrupt joint venturer may file a claim against the bankrupt estate. 11 U.S.C. §§501 – 510. Because of the joint venturers' joint and several liability to third parties and the effect of the automatic stay and discharge provisions, a creditor of the joint venture (who is precluded from proceeding against the bankrupt joint venturer personally) also may pursue an action to collect all or any part of a debt of the joint venture from any of the non-bankrupt joint venturers. At the same time, however, the automatic stay and discharge provisions also bar the non-bankrupt joint venturers from pursuing an action personally against the bankrupt joint venturer to contribute a share of the debts of the joint venture, leaving them to make claims against the bankrupt estate as unsecured claimants.

The effect of one joint venturer's bankruptcy on the joint venture entity depends on whether the joint venture agreement constitutes an executory contract under the Bankruptcy Code and whether the bankrupt joint venturer's duties under the joint venture agreement involve nondelegable duties under applicable state law. As a general matter, if a joint venture agreement constitutes an executory contract, it will, like an unexpired lease, be subject to the assume-or-reject provisions of Bankruptcy Code §365. Unlike unexpired leases, however, the bankruptcy trustee may not assume an executory contract involving nondelegable duties if the trustee, and not the debtor, is in possession of the joint venture interest as a result of the bankruptcy proceeding. 11 U.S.C. §365(c)(1)(A).

Thus, the threshold inquiry is whether the joint venture agreement constitutes an executory contract. If it does not, then the assume-or-reject provisions under Bankruptcy Code §365 do not apply, the bankruptcy termination provisions under applicable non-bankruptcy law or the joint venture agreement will be enforceable, and the joint venture can be terminated upon the bankruptcy of one of the joint venturers. Even if a joint venture agreement does not constitute an executory contract, however, the automatic stay and discharge provisions still will preclude enforcement of all non-bankruptcy remedies against the bankrupt joint venturer (other than
termination of the joint venture). Moreover, the bankrupt joint venturer’s interest in the joint venture (regardless of whether it has been terminated) will become property of the bankrupt estate and may be sold to satisfy creditors’ claims. 11 U.S.C. §541(a).

If the joint venture agreement constitutes an executory contract and the bankrupt joint venturer holds the joint venture interest as a debtor-in-possession, then the assume-or-reject provisions under Bankruptcy Code §365 apply. On the other hand, if the joint venture agreement constitutes an executory contract and the trustee holds the joint venture interest, it is then necessary to determine whether the bankrupt joint venturer’s duties under applicable state law are nondelegable. If they are delegable, then the assume-or-reject provisions under §365 apply. If, however, they are not delegable and the trustee is in possession of the joint venture interest, the result is uncertain because of an apparent conflict between two Bankruptcy Code provisions.

Bankruptcy Code §365(c)(1)(A) prohibits assumptions or assignments of executory joint venture agreements if the trustee is in possession of the joint venture interest and applicable state law would excuse the non-bankrupt joint venturers from accepting performance from “an entity other than the debtor or the debtor in possession.” In other words, §365(c)(1)(A) allows assumptions and assignments of executory joint venture agreements involving nondelegable duties if the bankrupt joint venturer remains as debtor-in-possession of the joint venture interest. On the other hand, §365(c)(2)(A)(i) provides that ipso facto bankruptcy termination provisions under applicable state law or the joint venture agreement are enforceable if applicable state law would excuse the non-bankrupt joint venturers from accepting performance of the bankrupt joint venturer’s duties from the trustee or an assignee of the bankrupt joint venturer’s interest. Thus, the conflict is that a joint venture agreement could be deemed to be an assumable executory contract under §365(c)(1)(A) and also be deemed automatically terminated under §365(c)(2)(A)(i). See Landers, Memorandum re Joint Venture Agreements and the Effect of a Bankruptcy Proceeding Involving One of the Venturers, REALTY JOINT VENTURES 1982 — CAPITAL SOURCES, NEGOTIATION AND DOCUMENTATION, pp. 721, 724 – 725 (PLI 1982).

Assuming that joint venture agreements are executory contracts involving nondelegable duties, one possible interpretation is that all joint venture agreements automatically terminate upon the bankruptcy of one of the joint venturers. This interpretation would leave Bankruptcy Code §365(c)(1)(A) without meaning for joint ventures. Thus, the more likely legislative intent is that §365(c)(1)(A) supersedes §365(c)(2)(A)(i) and that all joint venture agreements do not terminate automatically if one of the joint venturers files for bankruptcy.

Although the term “executory contract” is not defined in the Bankruptcy Code, “it generally includes contracts on which performance remains due to some extent on both sides.” H.R.Rep. No. 595, 95th Cong., 1st Sess. 347 (1977); S.Rep. No. 989, 95th Cong., 2d Sess. 581 (1978). In each of the two principal cases that have addressed the issue, the courts have held that partnership agreements are executory contracts under Bankruptcy Code §365. In re Norquist, 43 B.R. 224, 228 (Bankr. E.D.Wash. 1984), allowed a bankrupt general partner to reject the partnership agreement as an executory contract, the court reasoning that “every contract which requires substantial performance by either party to the agreement other than the payment of money is potentially executory in the bankruptcy context.” Because Norquist involved rejection of an
executory contract, the issue of whether the agreement involved nondelegable duties was apparently not before the court. However, *Bee Rock Development v. Harms (In re Harms)*, 10 B.R. 817, 821 (Bankr. D.Colo. 1981), determined that a partnership agreement is an executory contract that involves nondelegable duties because it is a "contract based upon personal trust and confidence." The partnership agreement ultimately was rejected, and the other partners were not required to accept performance from a substituted partner. Thus, although the law is still being developed in this area, these cases indicate that joint venture agreements probably will be treated as executory contracts involving nondelegable duties that are assumable unless the trustee is in possession of the joint venture interest.

Assuming that a joint venture agreement constitutes an executory contract under Bankruptcy Code §365, either involving nondelegable duties of a bankrupt joint venturer as debtor-in-possession or involving delegable duties, the fact that one of the joint venturers is in bankruptcy cannot cause the joint venture to be terminated under applicable non-bankruptcy laws or the provisions of the joint venture agreement. The debtor-in-possession or, if delegable duties are involved, the bankruptcy trustee must elect to assume or reject the joint venture agreement. If the bankrupt joint venturer is not a debtor-in-possession and nondelegable duties are involved, the trustee must reject the joint venture agreement. If either the bankruptcy trustee is entitled to and elects, or the debtor-in-possession elects, to assume the joint venture agreement, all defaults of the bankrupt joint venturer under the joint venture agreement must be cured, and adequate assurance for future performance must be provided. 11 U.S.C. §365(b)(1). In addition, if the joint venture agreement is assumed, the bankruptcy trustee or debtor-in-possession may assign the bankrupt joint venturer’s interest in the joint venture if the assignee gives adequate assurance of future performance. 11 U.S.C. §365(c). Such an assignment relieves the bankrupt joint venturer from defaults occurring subsequent to the assignment, and proceeds from sale of the joint venturer’s interest become property of the bankruptcy estate. 11 U.S.C §365(k).

If the trustee or debtor-in-possession elects to assume and retain the joint venturer’s interest in the joint venture, all obligations that accrue after the filing of the petition become an administrative charge entitled to priority against all other unsecured claims against the bankruptcy estate. 11 U.S.C. §507(a)(1). If the debtor-in-possession rejects the joint venture agreement or the bankruptcy trustee elects to or must reject the joint venture agreement, all of the bankrupt joint venturer’s obligations for future performance under the joint venture agreement are terminated. 11 U.S.C. §365(a). Rejection of the joint venture agreement constitutes a breach of the agreement by the bankrupt joint venturer, however, which entitles the other joint venturers to claim damages as unsecured creditors.

**F. [5.77] Effects of Recharacterization**

If a sale and leaseback transaction is upheld and not recharacterized in a bankruptcy proceeding, the bankruptcy estate of the seller-tenant must elect whether to assume or reject the lease. If the lease is assumed, the buyer-landlord will continue to receive rent payments as a first priority administrative expense of the bankruptcy estate. 11 U.S.C. §507(a)(1). The bankruptcy trustee is most likely to assume the lease if the debtor’s business depends on the location or suitability of the leased premises or if the lease is valuable and can be sold to generate cash for the benefit of creditors. In either case, the buyer-landlord continues to receive the benefit of the
bargain. If the lease is rejected, the buyer-landlord regains possession of the leased premises, is free to relet the leased premises, and also can file an unsecured claim for unpaid rent. If, however, the lease is recharacterized as a loan or joint venture, the buyer-landlord must choose from the much more complicated, and often less advantageous, rights and remedies under the Bankruptcy Code available to lenders or non-bankrupt joint venturers. In addition, recharacterization of sale and leaseback as a loan or a joint venture may have other ramifications.

For example, a lease calling for participation in the upside of the project — through payment of part of the net cash flow or of the proceeds from a sale or financing of the leasehold estate as additional rent — may withstand the problems of a seller-tenant’s bankruptcy better than a sale and leaseback recharacterized as a secured loan (with equivalent participatory interest) or as a joint venture (with the participation recharacterized as a joint venture distribution). If the trustee assumes the lease, the additional rent provisions will survive. If the trustee rejects the lease, the buyer-landlord will acquire title to the property free of the lease and may attempt to realize the property’s full potential.

If reduced to the status of a mortgagee, the buyer-landlord may be required to settle for a return of principal plus, perhaps, accrued interest while foregoing any future participatory interest — the initial inducement for entering into the transaction. If reduced to the status of a joint venturer, any claim the buyer-landlord may assert against the seller-tenant for past due fixed and participatory rent will be reduced to an unsecured claim for joint venture distributions, which must be filed against the seller-tenant’s bankruptcy estate. The buyer-landlord’s ability to realize future distributions will depend on whether the joint venture is continued. If the joint venture agreement is assumed, the buyer-landlord must rely for future performance on the original seller-tenant (who has already failed once) or, perhaps, on an assignee of the bankrupt’s joint venture interest. If the joint venture agreement cannot be assumed or can be assumed but is rejected and terminated, the buyer-landlord is left with an action for an accounting with the bankruptcy estate as one of the parties.

A bankrupt seller-tenant may seek to have a sale and leaseback transaction recharacterized as a loan to take advantage of the strong-arm powers of the bankruptcy trustee to gain title to the property and reduce the buyer-landlord to an unsecured creditor. If the formalities of state law dealing with passage of title are complied with in a sale and leaseback transaction, however, the risk to a buyer-landlord of both losing title to the property and becoming an unsecured creditor seems quite remote. Recordation of an absolute deed should be a sufficient perfection of the lessor’s rights in the property as a mortgagee even if the deed is deemed by the bankruptcy court to be for purposes of security and not an absolute transfer. Nevertheless, the possibility of reduction to unsecured status remains theoretically viable, especially if all the formalities of state law necessary for the conveyance of title have not been followed. In rare cases, a purported buyer-landlord may find itself transformed into an unsecured lender.

A bankrupt seller-tenant also may seek to have a sale and leaseback transaction recharacterized as a secured loan to benefit from the equity of redemption and other protections afforded a mortgagor by the applicable state law. If the transaction is recharacterized as a secured loan, the buyer-landlord-mortgagee will be faced with the problem of foreclosing a mortgage without the benefit of a waiver of the rights of redemption and without the benefit of the various
covenants usually contained in a mortgage and applicable in the case of default (for example, an agreement that the mortgage secures all money expended by the mortgagee to cure the mortgagor’s default, notwithstanding that the total amount secured by the mortgage exceeds the face amount of the note).

Recharacterization of a sale and leaseback transaction as a loan may, in turn, constitute a usurious loan. Often the percentage rate of return built into a sale and leaseback transaction (or the combined rate of return from the lease and the interest paid by the seller-tenant as leasehold mortgagor to the buyer-landlord as leasehold-mortgagor pursuant to a separate leasehold mortgage made as part of the whole transaction) will exceed the interest rate permissible under applicable state law.

If a seller-tenant granted a mortgage on its leasehold estate created in connection with a sale and leaseback transaction and, after becoming bankrupt, succeeds in having the underlying sale and leaseback transaction recharacterized as a secured loan, the status of the leasehold mortgage is called into question. The leasehold-mortgagor presumably could become a second mortgagee of the fee (assuming the sale and leaseback recharacterized as a secured loan is given priority) because the seller-tenant is deemed to be the owner of the fee. Alternatively, the leasehold mortgagor could be reduced to the status of an unsecured creditor because the property encumbered by the mortgage (the leasehold estate) is deemed not to exist as a matter of law.

A bankrupt seller-tenant may seek to have the transaction recharacterized as a joint venture. In such case, the court must resolve questions such as the joint venture interests of the joint venturers, the capital accounts of the joint venturers, and the other necessary components of a joint venture — issues usually negotiated at length by parties to a joint venture agreement. Although there appear to be no reported cases directly on point, a court ascertaining the buyer-landlord’s interest in the joint venture presumably would determine it to be either the proportion that the purchase price paid by the buyer-landlord for the real estate bears to the total value of the real estate or, in a participatory lease situation, the buyer-landlord’s share in the “upside.”

If the seller-tenant is successful in recharacterizing the sale and leaseback transaction as a joint venture, the buyer-landlord’s status would be reduced from the owner of the subject real estate to a coowner of the joint venture that owns the real estate. As a consequence, both the seller-tenant and the third-party creditors of the seller-tenant can attempt to take advantage of the buyer-landlord’s resulting joint and several liability by shifting liability for all of the debts of the seller-tenant incurred in connection with the joint venture to the buyer-landlord. At the same time, the buyer-landlord’s right to contribution from the seller-tenant as a co-venturer for the joint venture’s debts would be barred by the automatic stay and discharge provisions. Thus, the buyer-landlord could be liable for all of the debts of the joint venture and left with only an unsecured claim against the bankruptcy estate for the bankrupt joint venturer’s share of the debts of the joint venture.

Finally, upon recharacterization of a sale and leaseback transaction as a loan or joint venture by a court in a bankruptcy proceeding, the non-bankrupt party runs the risk that the transaction also will be treated as a loan or joint venture for tax purposes. Although a determination by the court in a bankruptcy context is not binding on the IRS or the courts in deciding whether the
transaction should be recharacterized as a loan or a joint venture for tax purposes, such a bankruptcy determination may predispose the taxing authorities to reach the same conclusion. If the transaction is, in fact, recharacterized for tax purposes, the tax benefits will be reallocated in a manner different from that originally intended by the parties. Although a detailed discussion of the tax ramifications of the recharacterization of a sale and leaseback transaction is beyond the scope of this chapter, at issue will be the gain or loss realized on the sale of the property, the deductions taken for rent under the lease, depreciation taken on improvements, and income in the form of rent or interest. In the context of a transaction such as a pre-1987 tax shelter syndication in which the non-bankrupt party has realized and intends in the future to realize substantial tax benefits from ownership of the real estate, a recharacterization for tax purposes could be disallowed, resulting in liability for past taxes plus interest and, perhaps, penalties. In addition, in transactions in which payment for the real estate by the buyer-landlord was motivated, at least in part by anticipated tax benefits, recharacterization for tax purposes could generate a major economic loss.

G. [5.78] Relevant Cases


In each of six cases involving real estate sale and leaseback transactions, the seller-tenant in bankruptcy sought to have the transaction recharacterized as either a loan or a joint venture. In two of these cases, Burke Investors v. Nite Lite Inns (In re Nite Lite Inns), 13 B.R. 900 (Bankr. S.D.Cal. 1981), and Fox v. Peck Iron & Metal Co., 25 B.R. 674 (Bankr. S.D.Cal. 1982), the court recharacterized real estate sale and leasebacks as loans. In Nite Lite Inns, the buyer-landlord was reduced to the status of an unsecured creditor when a proposed sale and leaseback transaction it had entered into was recharacterized as an unsecured loan. In recharacterizing this transaction, the court relied heavily on standards established in California usury cases challenging sale and leasebacks as usurious loans and on federal tax cases involving sale and leasebacks. The court determined that the buyer-landlord did not satisfy the federal test of significant and traditional lessor status and accordingly did not rise to the level of a secured lender. 13 B.R. at 913. Similarly, in Fox, the court ignored the structure of the transaction as a sale and leaseback and focused primarily on the economic substance of the transaction and relied on two "strong circumstances" in concluding that the sale and leaseback should be recharacterized as a loan: (1) the assets transferred to the buyer-landlord were worth at least twice as much as the amount of the purchase price; and (2) the repurchase provisions allowed the property to be returned to the seller-tenant for an amount equal to the original purchase price. 25 B.R. at 688 – 689.
In *In re PCH Associates*, 804 F.2d 193 (2d Cir. 1986), the court also determined that a true lease did not exist. In examining the substance rather than the form of the agreements, the court found that the transaction contained provisions that were inconsistent with a true sale and lease. 804 F.2d at 200. Thus, the court concluded that the transaction was structured as a lease only to achieve tax benefits for the lessee and higher guaranteed returns for the lessors. *Id.* The *PCH Associates* court, however, declined to follow the lower court’s findings that a joint venture had been created, stating instead that a lease did not exist and that the court did not find it necessary to identify the nature of the resulting transaction. Shortly after this ruling, the same parties brought another issue raised from the same bankruptcy procedures to the court, and, after thorough analysis, the court finally recharacterized the sale and leaseback transaction as a secured loan and the relationship between the seller-tenant and buyer-landlord as debtor and secured creditor. *In re PCH Associates*, 949 F.2d 585 (2d Cir. 1991). The latter *PCH Associates* court did not reduce the buyer-landlord to the status of an unsecured creditor, distinguishing from *Nite Lite Inns*, because the buyer-landlord in *PCH Associates* had actually acquired the title to the real property, while the buyer-landlord in *Nite Lite Inns* never did.

In the other two principal cases, *In re Kassuba*, 562 F.2d 511 (7th Cir. 1977), and *Chicoine v. Omne Partners II (In re Omne Partners II)*, 67 B.R. 793 (Bankr. D.N.H. 1986), the courts refused to recharacterize the sales and leasebacks and upheld the form of the transactions in similar fact situations. These courts refused to substitute their judgment for that of the parties in the principal transactions. In *Kassuba*, the court upheld the provisions of a ground lease that entitled the buyer-landlord to succeed to the title to both the land and improvements as a result of the seller-tenant’s default under the lease and his failure to exercise a repurchase option. 562 F.2d at 515. The court reasoned that the parties by contract may create a set of mutual economic benefits that is similar to a mortgage without conferring on each other the rights and liabilities of judicial foreclosure if that is what they actually intend. The substance of the transaction that a court of equity will examine is not its economic effect, which the parties determine by their agreement, but instead it is what their agreement is. 562 F.2d at 514.

Similarly, in *Omne Partners*, the court upheld the lease because the parties were both sophisticated in complex financing techniques and understood the terms of the transaction. There was no question, the court determined, that the parties negotiated and intended the transaction to be a sale and leaseback rather than a loan. 67 B.R. at 795. Therefore, the court upheld the lease, but the court left undecided whether the lease was terminated prior to the filing of the bankruptcy petition. 67 B.R. at 795 – 796.

In a more recent case, *In re Uni-Rty Corp.*, No. 96 Civ. 4573 (DAB), 1998 U.S. Dist. LEXIS 8426 (S.D.N.Y. 1998), aff’d, 175 F.3d 1008 (2d Cir. 1999), the court followed the logic of *Kassuba* and *Omne Partners* when it refused to disturb the findings of the bankruptcy court that the parties intended to create a true lease. In that case, the debtors sought a declaratory judgment that the agreement between the parties was not a sale-leaseback conveyance that entitled the defendants to evict them, but was instead more properly construed as a mortgage. Quoting *PCH Associates*, *supra*, the court stated that it must look to the economic substance of the transaction and not its form. 1998 U.S. Dist. LEXIS 8426 at **14 – 15. See also International Trade Administration v. Rensselaer Polytechnic Institute, 936 F.2d 744 (2d Cir. 1991). The court concluded that the debtors adduced no credible evidence to overcome the strong presumption that the sale-leaseback of the building in question created a true lease.
The courts of the Seventh Circuit have also reviewed this issue. In *United Airlines, Inc. v. HSBC Bank USA, N.A.*, 416 F.3d 609 (7th Cir. 2005), the Seventh Circuit ruled that a court must look to the state law for the state in which the property is located in order to determine whether a lease is a "true lease" or whether it is a financing arrangement. In this case, the court overruled the district court, which had also applied a state law analysis but had determined the lease in question was a true lease. In doing so, the court determined that under the law of the state in question (California) the lease was not a "true lease" and instead was merely a financing arrangement.

**H. [5.79] Preventing Recharacterization**

The list below outlines how to structure a sale-leaseback transaction so that it will not be recharacterized as a joint venture or a partnership:

1. The lease should mirror, as closely as possible, leases being used by parties in arm’s-length transactions that do not include a sale.

2. If the lease is a percentage rent lease, the lessor should present itself as a passive approver of such profit-making aspects of the lessee’s business as its annual budgets, long-term employment and management contracts, expenditures in excess of budgets, changes in the basic nature of the business, and sale of all or substantially all of the business’s assets. The lessor could also insist that pay scales and contract prices are in line with current market standards. The fact that the lessor’s involvement is limited to approving the lessee’s decisions safeguards its interest in achieving the maximum amount of profit and reinforces its image as a passive party.

3. The lease documents should clearly state that
   
   a. the parties are entering into a "lease arrangement" and not a joint venture or partnership;

   b. the lessor would not have entered into the transaction if another relationship were being created; and

   c. the lessee will not challenge the characterization of the arrangement as a lease if the lessor subsequently seeks to enforce its rights under the lease as lessor.

If the parties to the transaction are sophisticated and represented by counsel, such a recital (if true) may persuade the court that the lessee knowingly entered into the transaction.

4. The lessor should insist that a memorandum of lease be duly recorded in the office of the local recorder. The document should clearly describe the lessor-lessee relationship as well as the premises and parties affected by the lease. A court of equity may freely ignore the form of the transaction if it feels that a third-party creditor would be prejudiced by such a holding. However, the third-party creditor’s burden of proving a partnership or joint venture relationship may be more difficult if a recorded notice of the lease relationship preexisted the establishment of the third party’s credit relationship with the lessee.
5. The lessor might consider including a lease provision stipulating that if the transaction is recharacterized, the profits and losses will be allocated among the partners on the basis of the percentages that would have been allocated if a joint venture or partnership had been intended. The risk of adopting such a provision is that it acknowledges the possibility of a recharacterization. This could cause a court that is sympathetic to debtors to reason that a recharacterization will not be catastrophic since the buyer-lesser is aware of exactly what its profit (or loss) would be.

The effect of such a provision may be somewhat mitigated if the parties include a parallel provision stating that the parties do not intend their relationship to be construed as either a joint venture or a partnership. In any event, this entire issue is moot if there are no profits or losses to be shared.

VI. ENVIRONMENTAL CONSIDERATIONS IN SALE AND LEASEBACK TRANSACTIONS

A. [5.80] In General

Environmental matters are now the subject of serious and concentrated attention. This heightened attention and concern require careful consideration of environmental matters as an integral part of the planning process when structuring a sale and leaseback transaction. This planning must occur at the time a proposed transaction is structured and before the relationship between the parties as seller-tenant and buyer-landlord is in place. In addition, after the documents have been drafted and the transaction is in place, the parties must remain sensitive to environmental matters (and to the possible consequences of changing environmental circumstances) in connection with the way the seller-tenant and buyer-landlord conduct their activities for the duration of their relationship.

Sections 5.81 – 5.87 below discuss some of the matters in the area of environmental concerns that should be considered when structuring a sale and leaseback transaction and relationship. In this connection, these sections consider the ways in which the environmental concerns experienced by the parties to a sale and leaseback transaction may differ in character and consequence from the environmental concerns of those involved in other types of real estate transactions.

B. Planning Considerations

1. [5.81] Seller-Tenant's Initial Knowledge and Liability — Planning Considerations for Seller-Tenant

The prospective seller-tenant, as the owner of the property, is charged at the outset of the transaction with already knowing whatever there is to know about environmental matters affecting the property. As between the two parties to the proposed sale and leaseback transaction, the seller-tenant is initially responsible for the cleanup or other curing of existing environmental problems. Since the seller-tenant already has this level of responsibility for existing
environmental conditions and since the prospective buyer-landlord has no responsibility in advance of the transaction for such initial conditions, the seller-tenant should not expect that the structure of the transaction will enable it to lay off on the buyer-landlord any of the seller-tenant’s responsibility for environmental circumstances. This rule generally remains true unless the parties specifically agree that the buyer-landlord will assume these responsibilities and indemnify the seller-tenant from liability in connection with these responsibilities. Even in the case of such an agreement, the seller-tenant must rely on the ability of the buyer-landlord to perform its undertakings since such an agreement will not relieve the seller-tenant from liability to governmental authorities and other third parties.

2. [5.82] Planning Considerations for Buyer-Landlord

The buyer-landlord’s goal in planning and structuring the transaction is that it may be as free as possible from liability for adverse environmental conditions existing on the property or arising at any time during the transaction.

The prospective buyer-landlord does not want to unwittingly acquire contaminated property. If the property is environmentally contaminated, the buyer-landlord upon acquiring it will in all probability become liable for cleanup costs under federal law (Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA), 42 U.S.C. §9601, et seq.) and, in many cases, will also incur liability under state environmental protection laws.

The prospective buyer-landlord in a sale and leaseback transaction is even more concerned with protecting its position with respect to environmental matters at the pre-transaction stage than is a prospective mortgagee. The prospective mortgagee will incur liability only if it becomes the titleholder of the property following the mortgagor’s default and the subsequent foreclosure of the mortgage (or if it becomes too involved with the business of a borrower who contaminates the property). On the other hand, the prospective buyer-landlord is going to go into title at the inception of the transaction. Thus, the prospective buyer-landlord immediately incurs the full range of environmental liability that comes with the ownership of the property unless a court holds differently under CERCLA or some other comparable exemption under state law.

For example, in Kemp Industries, Inc. v. Safety Light Corp., 857 F.Supp. 373 (D.N.J. 1994), the court explained that CERCLA imposes liability for an environmental cleanup on the “owner” of the property but contains a secured lender exemption; in other words, it exempts a party that holds indicia of ownership primarily to protect a security interest in the property. New Jersey law contains a similar exemption under the New Jersey Spill Compensation and Control Act, N.J.Stat.Ann. §58:10-23.11. The court in Kemp applied these exemptions to the buyer-landlord in a sale and leaseback transaction, holding that the buyer-landlord was entitled to protection under the exemptions even though (a) the buyer-landlord held fee-simple title to the property, (b) the seller-tenant had no repurchase option, (c) the buyer-landlord took income tax deductions for the depreciation of the property, and (d) the buyer-landlord was entitled to any condemnation award should the government take the property.

In coming to this conclusion, the Kemp court looked to whether the totality of the circumstances indicated that the transaction was intended to be a “true lease” or a security
interest, as determined by the intent of the parties at the time the transaction was entered into. The court ultimately decided that the buyer-landlord, who never had possession of the property and lacked the capability to run the facility on the property, sought a fixed return on its investment rather than a profit from the appreciation or operation of the property, and thus held title as a security interest. See also Waterville Industries, Inc. v. Finance Authority of Maine, 984 F.2d 549 (1st Cir. 1993); In re Bergsoe Metal Corp., 910 F.2d 668 (9th Cir. 1990).

Despite the holding in Kemp, the prospective buyer-landlord has a pressing need to have full knowledge of the environmental condition of the property proposed for the transaction and the costs of curing any environmental contamination before entering into any binding arrangement to purchase it and to lease it back to the prospective seller-tenant.

In addition to the foregoing, there are state statutory considerations that make it advisable for a buyer-landlord to enter into a transaction only after it has complete knowledge of the environmental condition of the property. An increasing number of states have enacted laws requiring, in effect, that the purchaser become familiar with the environmental condition of property being purchased. Under these laws, when the prospective purchaser subsequently seeks to sell the property, it is charged with providing detailed information concerning the environmental history of the property in question. This history includes not just events that took place during prior ownership. The prospective buyer-landlord should obtain this latter information from its prospective seller-tenant and from examination of the property itself and then evaluate it before becoming the owner of the property.

Ideally, from the prospective buyer-landlord’s viewpoint, as much due diligence as possible should be accomplished by the prospective buyer-landlord even before the parties enter into a contract. If property being considered for purchase by a prospective buyer-landlord is environmentally contaminated, the value of that property to the buyer-landlord may be substantially reduced by the cleanup costs. Whether the cleanup is to be performed by the prospective seller-tenant or buyer-landlord, if the cleanup and related curative costs are large, the amount of cash remaining available to the prospective seller-tenant for other purposes may be substantially reduced. This reduction in the amount of the purchase price available to the prospective seller-tenant could in some cases render the transaction commercially undesirable. Accordingly, the financial impact of any required environmental cleanup should be determined as early in the planning process as possible in order to determine whether it will have a fatal impact on the transaction. If this is the case, all parties would be well served in not continuing to expend valuable resources and time on a transaction that will ultimately fail because of environmental problems.

To help evaluate adverse environmental consequences that may have resulted from prior uses of the property, the prospective buyer-landlord should familiarize itself with the past and present uses made of the property by the prospective seller-tenant, by its lessees, and to the extent possible, by prior owners and occupants. In addition, the likely environmental consequences of the uses the prospective seller-tenant (and those who will be its sublessees) intends to make of the property during the lease term should be considered carefully.
The prospective buyer-landlord should, at a minimum, inspect the site to determine whether any obvious environmental contamination exists. If practical, during the pre-transaction planning stage (and certainly before consummating its purchase), the prospective buyer-landlord should also require an environmental examination and assessment of the property to be conducted by professional environmental inspectors satisfactory to it. The extent of the required environmental examination will best be determined after consultation with the professional engaged to conduct it. The buyer-landlord should maintain the flexibility to require as thorough an examination as may be recommended by its environmental experts, based on the apparent condition and past history of use of the property. Because the environmental inspection can be costly, the prospective seller-tenant may be unwilling to pay for the inspection before a binding contract or commitment is entered into even though it probably cannot sell the property without such a study having been made. One solution that would at least allow the initial environmental audit to go forward at an early planning stage, in order to determine whether insurmountable environmental problems exist, is for the prospective buyer-landlord to pay the cost of the environmental examination initially with the understanding that if a contract or commitment to do the contemplated transaction is subsequently entered into, the buyer-landlord will receive a credit to the purchase price for the amount paid during the pre-transaction planning phase.

During the pre-transaction stage, the prospective buyer-landlord should review whatever available records may exist concerning the property. These records should include the latest title insurance policy (including any new title commitment that may be available), the latest plat of survey, copies of leases from the seller-tenant to its lessees, any environmental certifications that the seller-tenant may have received from its predecessors in title, and copies of any documents relating to environmental enforcement actions instituted or threatened by federal or state authorities with respect to the property. Information derived from these sources can help the prospective buyer-landlord evaluate environmental risks associated with the property being considered.

Obtaining information on environmental conditions of adjacent property may also benefit the prospective buyer-landlord. Some types of environmental contamination on adjacent property could have migrated (or might migrate in the future) from the adjacent property and create a risk of environmental problems for the property being considered for purchase.

If the prospective buyer-landlord determines that there are known or suspected cleanup costs affecting the property but the parties still wish to try to proceed with the transaction, the prospective buyer-landlord should consider how best to structure the transaction to ensure that the necessary cleanup will take place without adverse economic consequences to itself.

C. [5.83] Preparation of Documents

If the prospective parties have decided to proceed with the transaction after analyzing the environmental issues during their pre-transaction planning, they must then determine what provisions as to environmental matters should be included in two principal operative documents — the contract and the lease. Often, the best alternative from the buyer-landlord’s perspective is to require the prospective seller-tenant to take the necessary corrective action prior to the closing of the acquisition. If the seller-tenant is to cure environmental defects but this cannot be done
before closing, at a minimum the operative documents should include (1) a covenant that the
seller-tenant will cure the problem at its expense within a certain time, failing which the buyer-
landlord may take necessary corrective action at the seller-tenant’s expense; and (2) an
indemnification and hold-harmless agreement by which the seller-tenant will protect the
prospective buyer-landlord against any cost or liability arising by reason of the environmental
defect. The buyer-landlord might require a holdback at closing of a portion of the purchase price
as a fund to protect it against exposure to expense from post-closing environmental cleanup. The
level of protection the prospective buyer-landlord can achieve will depend on the relative
bargaining strengths of the parties.

1. [5.84] Contract or Commitment

The contract or commitment should include provisions that will cover the concerns of both
parties as to environmental matters with respect to the property. Agreed solutions to known or
potential environmental problems — often of significant importance to the bringing about of the
parties’ meeting of the minds on the whole transaction — should be clearly spelled out in the
contract. In addition to provisions agreed to by the parties on the curing of known environmental
defects, as set out in §5.83 above, the contract or commitment should include the provisions
outlined in §§5.85 – 5.87 below.

2. [5.85] Facts at the Outset — Seller’s Representations, Warranties, and Covenants

From both the buyer-landlord’s and the seller-tenant’s viewpoint, the contract or commitment
should include complete representations and warranties by which the seller-tenant provides the
buyer-landlord with all information the seller-tenant has concerning the present and prior use of
the property in question. The seller-tenant should describe not only the use or uses made by it of
the property in question, but also the use or uses made of the property by its present or past
lessees and, to the extent seller-tenant has knowledge, by the seller-tenant’s predecessors in title,
their lessees, and the other prior occupants of the property. If appropriate, the seller-tenant should
provide similar information, to the extent that the seller-tenant has it, as to adjacent properties. A
complete disclosure will allow the buyer-landlord to make an informed decision to purchase.

From the seller-tenant’s viewpoint, if there are any adverse environmental conditions
affecting the property or any risks of environmental enforcement actions and the buyer-landlord
is willing to accept these conditions or risks, the acceptable conditions or risks should be detailed
in the contract or commitment. A detailed statement of these conditions or risks will provide a
defense to the seller-tenant against claims by the buyer-landlord for environmental defects and
their consequences since the buyer-landlord entered into the transaction knowing of the defects.

The buyer-landlord should require the seller-tenant to warrant the truth of all of the
information given or provided by it to the buyer-landlord concerning the environmental condition
of the property and related environmental circumstances. The buyer-landlord’s decision to
proceed with the transaction may have been based in part on this information.

If statements about environmental matters with respect to the property are required by
applicable law to be given by sellers to buyers, the buyer-landlord is well served if the contract
requires the seller-tenant to prepare and deliver these statements for review and evaluation by the buyer-landlord well in advance of the proposed closing. This tool will again aid the buyer-landlord to make a knowledgeable decision to consummate the transaction in light of any environmental defects that are disclosed.

The seller-tenant should also state the uses it and those who may hold possession under it (e.g., any sublessees) plan to make of the property. The seller-tenant should represent that none of these uses will have an adverse environmental effect on the property. (The accuracy of this representation should be independently verified by the buyer-landlord.) The seller-tenant should also covenant that no use of the property by the seller-tenant or by anyone holding possession under the seller-tenant during the term of the leaseback to it from the buyer-landlord will create any new situations involving violation of environmental laws or regulations or will expose the property or the buyer-landlord to environmental enforcement actions. (As stated below, this covenant should also be included in the lease as a lessee’s covenant.)

All of these representations, warranties, and covenants should be structured to survive the closing of the sale and to remain effective for the full term of the lease and for the duration of the relationship between the seller-tenant and the buyer-landlord as to the property in question. Under the law of some states, some or all of these representations will be deemed to have merged into the deed at closing and not to have survived the closing unless the parties express a contrary intent in the contract or commitment. The contract should also clearly state that these representations, warranties, and covenants are of the essence of the transaction, thus providing a basis for a claim for damages and possible rescission if they are violated.

The contract or commitment should contain appropriate indemnification and hold-harmless agreements by the seller-tenant for the benefit of the buyer-landlord. These provisions should be tailored to fit the agreement of the parties as to what, if any, adverse environmental conditions and enforcement risks are acceptable to the buyer-landlord. If the parties have agreed that the buyer-landlord will not take on the risk of any adverse environmental conditions or enforcement risks, the indemnification and hold-harmless provisions should be drafted accordingly.

The buyer-landlord should be wary of the financial reliability of the party making the representations, warranties, and covenants and providing the indemnification and hold-harmless undertakings. If the contract is a nonrecourse contract for the seller-tenant or if the seller-tenant is an entity without significant assets, the agreements may provide no basis for a meaningful recovery of damages. If the seller-tenant has substantial assets, the buyer-landlord may wish to require an exception to the nonrecourse nature of the contract to provide a meaningful remedy in the case of a breach of the environmental undertakings. If the seller-tenant is without substantial assets, the buyer-landlord may consider asking the seller-tenant to provide a third-party guarantor or other security to back up the protection to be given the buyer-landlord under the indemnification and hold-harmless provisions. These decisions take on great significance when dealing with environmental undertakings because of the enormity of the liability to which the buyer-landlord in a sale and leaseback transaction may be exposed as the owner of the property after the closing of the purchase.
3. [5.86] Purchaser’s Right To Investigate Environmental Facts — Due-Diligence Period

In addition to obligating the seller-tenant to disclose whatever knowledge the seller-tenant has concerning environmental matters pertaining to the property, to the extent the buyer-landlord has not done so during the pre-transaction planning stage, the buyer-landlord should reserve the opportunity to make its own examination of the property as to such matters and then to decide whether to consummate the sale and leaseback transaction. In this effort, the buyer-landlord should have the aid of professional environmental consultants who the buyer-landlord believes are qualified to give the buyer-landlord independent expert advice as to whether the property presents environmental risks for the buyer-landlord upon its taking title. While the seller-tenant’s representations, warranties, covenants, and undertakings provide a basis for a suit by the buyer-landlord for damages or even rescission, the best position for the buyer-landlord to be in is to avoid consummating the transaction if unacceptable environmental risks are discovered before closing. Since the seller-tenant will have difficulty selling the property without an independent environmental inspection, the buyer-landlord should seek to have the seller-tenant pay the costs of the consultant.

The buyer-landlord should insist that the contract or commitment provide for an adequate period of time to conduct a reasonable due-diligence investigation of the environmental condition of the property and that the buyer-landlord and its consultants have access to the property and to the seller-tenant’s records in order to do an adequate inspection. While the exact amount of time required for this investigation will depend on the size of the property, its known past uses, and the work schedule of the consultants, at least 45 days, if possible, should be reserved for the preliminary inspection. If the preliminary inspection suggests that a more detailed inspection is necessary, the contract or commitment should allow reasonable additional time for a more detailed inspection to be completed. The buyer-landlord should then have a reasonable additional period after receipt of the report within which to decide whether conditions found by the consultants are acceptable or whether the conditions are unsatisfactory. An additional 15 days may be adequate for this.

The contract or commitment should provide for alternative courses of action if the environmental conditions found show unacceptable risks of cleanup liability or if the buyer-landlord’s investigation turns up facts suggesting existing violations of environmental law, the need for reports to be made to governmental authorities, or other environmental enforcement action for which the buyer-landlord could become responsible upon its coming into title. In these circumstances, as an alternative, the buyer-landlord might be able to terminate the contract for a fixed period of time. As another alternative, the seller-tenant might be allowed to make all necessary corrections and to cure those violations that can be quickly cured, with the contract or commitment to remain in effect as long as the seller-tenant performs these obligations promptly. An outside date might be set by which the initial violations are to be cured. For violations that would take longer to cure, the contract or commitment might entitle the seller-tenant to preserve the contract or commitment by covenaneting to take all necessary cleanup or other action after closing that is required to bring the property into environmental compliance. If there is any question about the seller-tenant’s reliability to perform its post-closing obligations, the seller-tenant’s undertaking should be accompanied by a holdback of a portion of the purchase price or
other security (such as a letter of credit) to ensure completion by the seller-tenant of its obligations. Still another alternative might be for the buyer-landlord to be able to require the seller-tenant to take the cleanup steps discussed above, although most seller-tenants will insist, if they are willing to agree to this, that the amount they must spend to cure environmental defects be capped.

D. [5.87] Environmental Provisions of Lease

The contract or commitment will call for a lease of the property back to the seller-tenant as lessee, to become effective when the sale to the purchaser is closed. Preferably, the lease should be attached to the contract or commitment as an exhibit, with the contract or commitment requiring the parties to execute the lease in substantially that form. If this procedure is followed, environmental considerations of special significance to the lessor-lessee relationship will have been addressed in the form of the lease. The seller-tenant and buyer-landlord will have become bound, upon executing the contract, to the use of a lease that properly addresses leasehold environmental matters. If the contract or commitment does not have the lease attached as an exhibit but rather spells out the principal terms of the lease that will be entered into at the closing of the sale, the contract or commitment should set forth certain basic points with respect to environmental matters that will bear on the relationship between the parties during the term of the lease.

Whether the lease is attached as an exhibit or the principal terms of the lease are set out in the contract or commitment, the following environmental considerations should be covered:

1. Note should be made that the seller-tenant, having been in possession of the property at the pre-transaction stage, will remain in possession throughout the lease term. Accordingly, the seller-tenant will have full responsibility for keeping the property free from environmental problems throughout the term of the lease.

2. The seller-tenant should agree to indemnify and hold the buyer-landlord harmless (a) in matters of environmental liability and possible environmental enforcement actions relating to the physical condition of the property up to the date of the closing, (b) in all matters arising with respect to the property at any time during the term of the lease, and (c) for as long thereafter as the seller-tenant retains possession of the property.

3. The lease should contain restrictions on uses of the property that could increase the exposure of the buyer-landlord to the risk of cleanup costs or of other environmental enforcement actions. These limitations should apply to uses both by the seller-tenant and by those holding possession under it. Since the buyer-landlord, as owner of the property, will be exposed to environmental liability that arises from the acts of the seller-tenant or its subtenants, the buyer-landlord must protect itself under the terms of the lease by controlling permissible uses of the property. If the permitted uses of the property could result in environmental contamination of the property, the seller-tenant should be required to deliver periodic environmental audits of the property throughout the terms of the lease so that the buyer-landlord can police the seller-tenant’s covenant to keep the property free from environmental contamination.
VII. [5.88] APPENDIX — ADDITIONAL SOURCES

For the attorney interested in pursuing further the subject of sale and leaseback financing, the following are a number of publications on the subject that may be of interest:

Periodicals


Clark, Louis M., Changing Considerations in Sales and Leaseback Transactions, 42 Taxes 725 (1964).

Davis, Real Estate Leasebacks from the Lessee’s Point of View, 3 Real Est.L.J. 454 (1976).


Howard, Norman A., Essential Elements of a Net Lease, 8 Pract.Law. 15 (Fall 1962).


**Books**


SALE AND LEASEBACK FINANCING (PLI, 1969).