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Master Leases: A Guaranty Substitute or the Gift that Keeps On Taking?

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I. INTRODUCTION

Through the ups and downs of the recent economic times, borrowers have faced ongoing hurdles when seeking financing for their commercial real estate ventures. For commercial real estate projects for which financing will be tied to rental income, a healthy income stream increases the project's value and attractiveness to lenders.

Utilizing the rental stream as the basis for financing commercial property brings with it a unique set of challenges related to the potential instability of the income flow associated with the rental space. Lenders often have concerns regarding potential gaps in the income stream that can result from current or future vacant space, the expiration of existing and future leases, and the lack of income or reduced income during free rent or reduced rent concession periods. These irregularities in cash flow are closely reviewed, analyzed, and weighed by lenders during their underwriting process.

In many cases, lenders will require some additional credit support or credit enhancement from the borrower to compensate for these potential income gaps. Sometimes, a traditional guaranty does not work. For example, the lender's underwriting requirements may require the property to generate certain levels of income. Although a traditional guaranty provides a lender with a potential backstop if the borrower does not pay, it does not address this particular more immediate underwriting concern. "The master tenant's rent obligation is the owner's shield against the uncertainty and variability inherent in changing rental markets."[1] In addition, a master lease can provide a similar shield to the lender.

As a substitute for a traditional guaranty agreement, borrowers may offer to lenders, or lenders may require, a master lease on the property to protect against potential revenue shortfalls in those instances discussed above. When used as an enhancement to obtain financing, as discussed in this article, the rent due under the master lease is assigned to the lender as additional collateral.

II. OVERVIEW OF A MASTER LEASE

Generally, a master lease is a lease to a creditworthy "master tenant" for all or a portion of an overall commercial project. The master lease provides additional financial protections to the lender and helps alleviate concerns about potential gaps in the revenue stream coming from the property.

Master leases can take many formats, such as:

- "The master tenant leases the entire project, and is deemed to be subleasing space to tenants in occupancy of their space;
- The master tenant leases specific vacant space only, and the master lease terminates with respect to space later leased to tenants in occupancy;
- The master lease covers only the vacant space in the project from time to time, so that the master premises 'float' to coincide with actual vacant space;
- The master lease covers specific space covered by a lease with an upcoming expiration, and takes effect only if that lease is not renewed or the space re-leased; [or]

[1] Cheryl P. Armata, *Lender Concerns About Master Leases*, 24 No. 2 Prac. Real Est. Law 59, March 2008.

- The master lease covers space leased to a tenant currently paying no rent due to a rent abatement period, but only during such period."[2]

When used as a credit enhancement, the master tenant is typically a related party to the owner of the property and to the borrower under the loan, such as a partner, member, affiliate, or subsidiary of the property owner or borrower. A lender will likely scrutinize the creditworthiness of the master tenant in a similar, if not the same, manner as the lender's scrutiny of the creditworthiness of a traditional guarantor.

III. <u>STRUCTURE OF A MASTER LEASE</u>

A. <u>In General</u>

A master lease is a lease of real property. The typical structure of a master lease looks very similar to a traditional lease, and contains similar rights, remedies, and defenses. However, with a master lease, the master tenant does not actually take possession of the property. Further, the master tenant does not always have the typical tenant responsibilities of procuring liability insurance and maintaining the property. "[B]ecause the master tenant has an obligation to pay the base rent as it comes due and to perform other tenant obligations in exchange for occupancy, a master lease looks like a space lease, with the tenant electing not to occupy."[3]

B. <u>Provisions of a Master Lease</u>

1. Remedies

Remedies under the master lease often include the right to accelerate the master tenant's rent upon default, enabling a remedy for the lender similar to calling the loan due in full.[4] In addition, a master lease provides for remedies to collect unpaid rent due under the master lease. An event of default under the loan agreement typically triggers an event of default under the related master lease. Therefore, each of the lender, the borrower, and the master tenant should pay particular attention to these matters, which may be highly negotiated.

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[2] Douglas P. Snyder, *Master Leases in Financing Transaction*, RPPT eReport, December 19, 2006.

[3] Cheryl P. Armata, *Lender Concerns About Master Leases*, 24 No. 2 Prac. Real Est. Law 59, March 2008.

[4] *See* Gregory G. Gosfield, *Manual on Guaranties and Sureties*, November 18, 2009, at 19, available at http://www.klehr.com/C7756B/assets/files/lawarticles/SCN_20100114141843_001.pdf.

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