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Authors:

[Panagiota "Patricia"](#)

[Koutsis](#)

[Emma H. Mulvaney](#)

[Geoffrey M. White](#)

Building on Borrowed Ground: Ins and Outs of Leasehold Mortgage Financing

Imagine this: A national retail chain signs a 25-year ground lease to build a flagship store on a prime urban parcel. The tenant will spend millions constructing the building, installing fixtures, and customizing the space, but they won't own the land. To finance these improvements, the tenant seeks a leasehold mortgage. This type of financing allows the tenant to borrow against its leasehold interest, ideally without negatively affecting the landlord's ownership of the property. While increasingly common, leasehold mortgages can carry significant risks. But what are the basic mechanics of leasehold financings, and why are they so important in the [retail and shopping center industry](#)?

This [Triple Net](#) blog post outlines what leasehold mortgage are, why they matter, the principal risks and benefits for tenants, landlords and their respective lenders, and practical steps each party can take to protect their legal and financial interests. Further blog posts will dive into each of these topics in greater detail.

How Leasehold Mortgages Work

Leasehold mortgages can be an essential tool in ground-leased developments, [build-to-suit arrangements](#), and long-term leases where tenants invest significant capital into improvements on property they lease but do not own in fee. Whereas a mortgage is a lien on real estate, typically on the fee simple interest in the property, leasehold mortgages are liens on the tenant's leasehold interest and can also cover the tenant's personal property, including improvements and fixtures. Importantly, a leasehold mortgage does not encumber the landlord's fee interest in the property.

Building on the retail chain scenario above, imagine a few years have passed. The tenant now faces financial difficulties and defaults on the leasehold mortgage. What happens next?

Because the mortgage is secured only by the leasehold interest, the tenant's lender does not gain ownership of the land. Instead, the lender may foreclose on the tenant's leasehold interest, meaning the lender can step into the tenant's shoes and either assume the lease or assign it to a new party, such as another retailer, assuming such assignment is in fact permitted. This allows the tenant's lender to preserve the value of its collateral (the lease and the improvements to the property) and potentially recover its investment. While foreclosure is never a desired outcome, replacement of a tenant to return the property to income production also benefits the landlord through preservation of the lease and rent.

Key Considerations for All Parties

1. Lease Terms

Prior to engaging with a lender, it is critical to understand the terms of the lease with respect to whether the tenant is permitted to place a lien, including a leasehold mortgage, on the property. Standard language in a landlord-drafted lease often prohibits leasehold mortgages or requires landlord consent for any leasehold mortgage. In some cases, the tenant is permitted to obtain financing for personal property but not allowed to encumber the leasehold interest with a mortgage. If a tenant is relying upon the availability of a leasehold mortgage to finance improvements to the leased premises, these issues should be a central focus of lease negotiations.

2. Leasehold Lender Considerations

Leasehold lenders aim to secure their limited property interest and minimize risks. To meet these goals, lenders will require certain lease terms. Specifically, the lease term must exceed the proposed loan term, and lenders must have the ability to cure tenant defaults, prevent lease termination, and assume or assign the lease after foreclosure. Additionally, as the leasehold mortgage will be recorded in the land records, lenders will require a recorded memorandum of lease between landlord and tenant to ensure the tenant's interest in

the property is properly included in the chain of title. Lenders are also generally concerned and require control over insurance proceeds following casualty or condemnation in order to ensure the property is properly restored and back to generating income. If the loan is securitized, syndicated, or the lender has other leasehold financing programmatic requirements, these and many other provisions will be negotiated at great length.

3. Landlord and Landlord-Lender Considerations

In a long-term lease, the landlord may have its own financing secured by the property, with rental income serving as a source of loan repayment. In such cases, the landlord and its lender will be concerned about any impairment of the landlord-lender's rights. Generally, in this situation, an intercreditor agreement (or similar recognition agreement) is required to establish the terms and priority of the mortgages. The landlord should ensure its fee lender retains the right to foreclose on the property while the lease remains in effect and rent continues to be paid. It is also important to coordinate the casualty or condemnation proceeds and restoration decisions to safeguard the residual value of the fee estate.

Benefits and Risks of Leasehold Mortgages

Leasehold mortgages allow tenants to access capital by using their leasehold interest and property improvements as collateral. They also provide a way to monetize long-term leases when direct ownership of the fee property is not possible, often at a lower cost than unsecured financing. For a lender, a leasehold mortgage can provide enhanced project viability through tenant access to capital. It also creates a structured framework for lender oversight, allowing lenders to monitor compliance with lease terms and intervene if necessary to protect their investment. Further, such improvements made to the land at the tenant's expense typically revert to the landlord when the lease expires, and lenders may leverage such financing to require the tenant to maintain stronger financial covenants and higher maintenance standards during the term of the lease. Additionally, the parties should consider the potential tax

implications of the financing.

Leasehold mortgages are not without their risks, however. Tenants face potential vulnerability and challenges obtaining financing if the landlord or its lender can terminate the lease before the leasehold lender can cure defaults, and cash flow challenges may arise from escalating rent, taxes, or operating expenses that strain debt service coverage. Landlords, by comparison, face risks such as operational complexity and delays due to the involvement of additional parties and documents, as well as a reduction in their control over property transfers and default remedies due to increased leasehold lender rights. Finally, conflicts may arise between the fee lender and leasehold lender if their respective remedies are not aligned, potentially complicating the resolution of defaults or foreclosure situations.

Bottom Line: Timing and Terms Are Key

Leasehold mortgages can be highly effective when the lease is drafted and administered with adequate protection and clear economics. It is critical to negotiate these provisions prior to the execution of the lease to allow for a smooth process. Although these provisions can be addressed later, it is generally more time- and cost-effective to deal with them while there is still interest in negotiating the lease and securing the tenancy. Thorough, early documentation and careful attention to lease terms protect all parties.

Please contact the authors or any attorney with Frost Brown Todd's [Retail and Shopping Center Finance](#) team if you have questions or need experienced guidance on any current or future leasehold mortgage financing.

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