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Subordination, Nondisturbance and Attornment Agreements: A Minimum Standard Tenant Checklist

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The recent economic upheaval, which has affected the viability of many commercial properties, should compel tenants expending a significant amount of money in leasehold improvements and/or those committing to a long-term lease, to require a nondisturbance agreement from all existing lenders and/or ground lessors. Without nondisturbance protection, a tenant cannot prevent its lease from being terminated after a default by the landlord on its mortgage. A lender can elect which tenants it wants to keep or replace, without the slightest consideration as to the tenant's economic investment or the years spent securing a strategic location or rental rate.

Lenders also have a compelling interest in creating a relationship with its bor-

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rower's tenants; however, lenders' interests are significantly different from those of a tenant. First and foremost, a lender wants to protect its lien position on the mortgaged collateral and will require a tenant to subordinate its leasehold interest to the mortgage as a condition to any nondisturbance. A lender also wants to ensure a steady stream of income from the mortgaged property after a foreclosure. Therefore, a lender will require a tenant to agree to attorn to the lender as its new landlord after a foreclosure.

Clearly both tenants and lenders have competing interests which must be protected and which are negotiated into a single document that intertwines the foregoing three concepts, namely, the Subordination, Non-Disturbance and Attornment Agreement ("SNDA"). This article focuses on the common issues that are negotiated in an SNDA, the typical positions of lenders and tenants, and the "minimum standards" a tenant should require in each instance.

Subordination: In order to protect its

lien position, a lender will require that the tenant subordinate its interest in its lease to the mortgage, and any amendments, renewals, extensions or modifications. It is critical that the tenant only agree to subordinate its interests to the lien of the mortgage. Otherwise, a tenant will be bound by the terms of the mortgage, which could be contrary to the terms of the lease.

Attornment: A lender will also require that the tenant agree to recognize the lender (or any successive owner after a foreclosure) as the new landlord under the lease after a foreclosure. This agreement creates direct privity of contract between the lender and the tenant and will carry forward the lease obligations of both parties under the lease, subject to any limitations in the SNDA.

Nondisturbance: In exchange for the subordination and attornment agreements for the benefit of the lender, the tenant will require that the lender agree to not disturb its interest in the lease after a foreclosure of the mortgage. Although the most basic

element to the nondisturbance agreement is the agreement by the lender not to terminate the lease after a foreclosure so long as the tenant is not in default under the terms of the lease (beyond all applicable notice and cure periods), the tenant should also require that the lender assume all of the obligations of the landlord. This part of the SNDA is the most heavily negotiated. A lender typically tries to water down its obligations under the lease, whereas the tenant tries to preserve its rights and require the lender to assume the same obligations that the landlord had agreed to perform under the lease. Common carve-outs that lenders often impose on a tenant are set forth below, and suggested exceptions that are critical to protecting a tenant's interest are listed afterward.

1. No liability for the defaults of the prior landlord and offset rights: The lender (or any successive owner after a foreclosure) should be liable for any defaults for which it has received notice of and which is of a continuing nature. In addition, the tenant should attempt to retain the right to offset for any default which the lender received notice and which is continuing, as well as the right to offset costs it expended in curing a landlord default.

2. No obligation for any construction obligations and/or tenant allowances: This carve-out should be strongly resisted. A tenant will have likely been induced to enter into the lease based on certain work being performed by the landlord and/or reimbursement for certain leasehold improvements. At a minimum, collection of any rental payments by the lender should be conditioned upon the lender completing any unfinished construction required to be performed by the landlord. The lease should provide that the tenant has the right to complete any landlord-required construction (together with a right to offset the cost of such construction from rent), and/or the right to offset against rent the amount of any unpaid tenant allowance. A tenant should also insist that this exception not apply to general repair and restoration obligations of the landlord under the lease.

3. Require notice of all landlord defaults and an opportunity to cure: It is reasonable for a tenant to agree to give the lender a copy of any notice of default

it delivers to the landlord; provided, however, (i) the failure to give such notice to the lender should not invalidate the default, (ii) the time period to cure any monetary default by the lender should coincide with the cure period set forth in the lease, and (iii) the time period to cure any nonmonetary default by the lender should only be extended to the extent reasonably necessary to allow the lender to obtain possession of the property (if necessary to cure such default), but in no event longer than a specific number of days.

4. Not bound by any representation or warranty of the prior landlord. If there are any specific representations or warranties that are particularly important to the tenant, the tenant should expressly list them in the SNDA and require that they be true and accurate as of the date the lender (or any successive owner) takes possession of the mortgaged property

5. Not bound by any security deposits or rent received more than one month in advance. Any payments that are actually transferred and received by the lender (or any successive owner) should be excluded from this exception, as well as any payments which are required to be paid under the lease, such as estimated CAM payments and/or tax payments.

6. No modifications to the lease without the lender's consent. Any modifications which arise out of an exercise of the tenant's rights contained in the lease (such as a renewal option or an explicit termination right) should be excluded from this limitation. In addition, a tenant should try to limit the lender's consent to any modifications which materially affect the monetary obligations under the lease, the use of the premises, the term of the lease and/or which increase the landlord's obligations under the lease. If the lender's consent is required, such consent should not be unreasonably withheld, conditioned or delayed and the lender should be required to respond within a certain period of time or be deemed to have given its consent.

7. Removal of all collateral rights (such as right of first refusal): This carve-out should be strongly resisted since such rights were likely material inducements to entering the lease; however, a tenant may acknowledge that a foreclosure

of the mortgage would not trigger its right of first refusal or right of first offer.

8. Require prior consent to any assignment/sublet or alterations: The lease will probably require the landlord's consent to an assignment of the lease or sublet of the premises and to most alterations, so any requirement of further consent by the lender should be rejected. At the most, only alterations which affect the structural components of the collateral, or the mechanical systems of the premises which affect other tenants, should require the lender's consent.

9. Require that all payments be made directly to the lender after a default by the landlord under the mortgage. This requirement should only be contained in SNDAs which the landlord is a party to and those which contain a provision wherein the landlord releases the tenant from any claims arising out of its direct payment to the lender after receiving a notice from the lender to make such payments to it directly.

10. Require prior consent to terminate the lease. There should be no obligation to obtain the lender's consent to terminate the lease if: (i) the tenant is not in default under the lease, (ii) the lease specifically gives the tenant such right, and (iii) the lender was given notice and an opportunity to cure such default, but failed to do so.

11. Limitation on the application of insurance proceeds and/or condemnation awards. A tenant should fight hard to have the terms of the lease govern the application of insurance proceeds and condemnation awards rather than allowing the lender the right to apply such amounts towards the amount due on the mortgage.

Generally, a lender will try to limit its lease obligations as much as possible. It is prudent for a tenant to negotiate the SNDA simultaneously with the negotiation of the lease. A tenant places itself in a much worse position if it waits until the last minute to negotiate this agreement. Although a larger, financially strong tenant may have more bargaining power, every tenant should ensure that certain protections be obtained from the lender in order to protect its investment in the lease. ■