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The Necessity To Obtain a Lender's Consent to a Lease Agreement

Look to the documentation for the answers

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Even though the economy may be showing glimpses of recovery in certain sectors, some tenants continue to struggle to meet lease obligations. Many tenants, either through economic necessity, or as an "across-the-board" policy, are seeking lease amendments from their landlords, including fixed rent reductions, operating expense reductions or caps, kick-out rights, more liberal assignment and sublet rights, and the right to give back space. If the property is subject to a mortgage, then making those lease modifications may not be so easy, as a mortgagee may have a right to interject itself in the negotiation process due to its concern that the collateral is in jeopardy. Conversely, tenants usually wish to avoid the delay and cost of obtaining a lender's consent. So, many tenants and landlords are asking the question of whether it is necessary to obtain a lender's consent to a lease amendment.

The place to start in answering this question is to review the lease and loan documentation to determine each party's rights and relative priority. Any lease signed after the mortgage will be subordinate and subject to the terms of the mortgage. Regardless of priority, many leases provide that the lease is subject and subordinate to all current and future mortgages. Likewise, many mortgages will contain a covenant wherein the landlord/borrower has agreed not to amend or terminate any lease without the lender's consent. Some borrowers are sophisticated enough to negotiate leasing parameters with their lender and include the parameters in the loan documents, so that, for example, consent is not required for amendments to existing leases, if the particular lease is for less than 10 percent of the floor area of the mortgaged property or represents less than 10 percent of the gross rent of the mortgaged property. So, if the tenant's lease is subordinate and the mortgage of record contains the covenant restricting lease amendments without obtaining the lender's consent, or sets forth criteria for when consent is, or is not, required, the answer to the question should be fairly straightforward, unless of course the language used is unclear or ambiguous.

Moreover, a lease, whether signed before or after a mortgage, may be subordinated to the mortgage by a Subordination, Non-Disturbance and Attornment Agreement (an "SNDA") signed between the lender and tenant. Many SNDA's contain an agreement by the tenant not to amend the lease without the lender's consent or an agreement that an amendment made without consent is not binding upon a subsequent foreclosing lender. A restriction on amendments may also be contained in an estoppel due to the fact that many lenders' form estoppels have broadened in scope in recent times. Many restrictions on lease amendments prohibit all amendments; others limit only certain changes, such as reductions in rent or lease term.

Another document to review in New Jersey cases is the Assignment of Leases and Rents. This will either be contained in the mortgage or in a separate document. Where the language of an assignment creates only a security interest then the analysis is no different from that stated above. However, where the assignment is abso-

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lute, New Jersey gives effect to the absolute nature of the assignment and in such cases, unless the assignment permits the landlord to enter into lease amendments, the lender's consent would be required as the lender, in such instance, is the party of record that holds the landlord's interest in the lease. Most loans include such an assignment and it, too, must be reviewed to determine the rights of the landlord and the tenant. So, while there can be no guaranty that the language used in the various documents will be clear, if the lease is subordinate to the mortgage, the mortgage will most likely answer the question whether a lender's consent is required to a lease amendment as even the simplest modern mortgage forms usually contain such restrictions. Likewise, if a tenant has agreed in an estoppel or SNDA not to amend the lease without the lender's consent, the interpretation of this agreement will most likely be determinative.

What if the lease has priority and was in place at the time the loan closed, the lease contains no automatic subordination language and no SNDA was signed or it was silent as to amendments? The general rule is that such a lease is not subordinate to a mortgage recorded subsequent to the lease. In those instances, the mortgagee is bound by all of the terms and conditions of any lease executed prior in time and, in the event of a foreclosure, is subject to the terms and conditions of the lease. While not free from doubt, it appears that, in New Jersey in those instances, landlords and tenants are free to modify and terminate such pre-existing leases, potentially to the detriment of the mortgagee. Although such modifications or amendments may be a violation of the landlord's obligations under the mortgage, that violation simply leaves the lender with another claim against its borrower. Absent an agreement to the contrary, the mortgagee has no privity with the tenant and cannot control the actions of the tenant until it ultimately forecloses. If the landlord defaults and the mortgagee forecloses, the mortgagee may find itself in the unenviable position of seeking to enforce the terms and conditions of the leases it used to underwrite the loan, but which have subsequently been modified.

Lenders in some states, such as New York, have a statutory method to avoid this result. In New York, Section 291-f of the Real Property Law permits a lender to protect itself by putting existing tenants on notice of the provisions in the mortgage preventing the landlord from modifying the lease without the mortgagee's consent. Essentially, once a tenant is put on notice by the mortgagee as required by Section 291-f, any lease modification, without the consent of the mortgagee, is voidable. New Jersey does not have a comparable statute.

As stated earlier, whether a lender's consent is required is not free from doubt. This doubt most likely arises between the conflict between "title-theory" and "lien-theory" states. Cases in title-theory states have held that the foreclosure of a deed of trust will transfer title free of any amendments to a lease, even a lease with priority, most likely because a lender acquiring title under the deed of trust acquires title free of matters subsequent to the deed of trust. See *R-Ranch Markets #2, Inc. v. Old Stone Bank*, 16 Cal.App.4th 1323, 21 Cal. Rptr.2d 21 (Cal. App. 4 Dist. 1993). The rationale offered in such cases was that it is a rule of public policy to protect lending institutions from fraudulent amendments to leases which would reduce the value of the property and discourage lending as the lenders would have no assurances that the borrower and the tenant would not amend the lease to the lender's detriment. We must wait to see if the logic of the title-theory states is applied, but a lender entering into a loan is always free to protect its position by requiring as a condition of the loan that the tenants enter into SDNA's with the appropriate agreements regarding amendments. New Jersey Courts have previously recognized that in the case where the lease has priority, a landlord/borrower and his tenant are free to modify or amend a lease and bind the mortgagee. *Kirkeby Corporation v. Cross Bridge Towers, Inc.,* 91 N.J.Super. 126 (Ch. Div. 1966). However this has certain limitations, including fraud or collusion, and amendments amounting to a novation. So, in a case dating back to earlier times of economic hardship, a New Jersey court recognized that rent reductions, legally and honestly agreed, are binding upon the lender. However, fraud or collusion to defeat the foreclosing lender would not bind a lender. See *Kenney v. 149 North Avenue Corporation*, 115 N.J. Eq. 314 (E. & A. 1934). Also, while a rent reduction in itself is most likely not a novation, substituting premises, increasing the size of premises and extending the term of a lease do run the risk of being interpreted as a novation, which would make the amended lease a "new lease" subsequent in time, and hence subordinate to the mortgage, and therefore subject to the treatment discussed above.

Most likely the answer to the question of whether a lender's consent is required to a lease amendment is contained in the lease and loan documentation. If a tenant ignores a review of the documentation or just fails to obtain the lender's consent, the tenant runs the risk of having the amendment declared void after the lender forecloses and possibly before. If the tenant is detrimentally relying on the amendment, such as, for example, relocating to a smaller space with the consequent expenditures for new tenant fit-out or paying in advance for a rent reduction, the prospect of having the amendment disregarded is potentially very serious. Where the amendment does not involve a tenant's detrimental reliance, such as in a negotiated rent reduction, the tenant may be more tempted to bypass a lender's review. In such a case the tenant should carefully weigh the consequences of failing to get the lender's consent. On the other hand, a lender is better served avoiding the uncertainty by providing for the issue in a SNDA. ■