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KEVIN F. JURSKINSKI, ESQ.
COMMERCIAL LEASE NEWSLETTERS

The Effect of Foreclosures on Commercial Property Tenants and
Landlords (continued)

In last month's newsletter we discussed the potential negative impact to a commercial property in the event of a foreclosure. Part and parcel with the issue involving commercial leases is the relationship between the commercial mortgagee and the commercial tenant. Here are some concepts to consider in regard to commercial leases and the interrelationship between the commercial tenant and the mortgagee having a mortgage on the subject property. This is an important relationship especially in light of the potential issues that could arise in the event of mortgagees calling loans or enforcing certain rights due to our troubled economy.

Priority Issue of the Mortgagee: Whether a commercial mortgage is in place for a commercial property or alternatively, the landlord needs to refinance, restructure its debt or obtain alternate financing, the lender is going to require that it has a priority position in regard to its mortgage superior to all other claims of parties, inclusive of tenants and their leasehold interest. Whether a tenant executes a lease subsequent to a mortgage being in place or whether a commercial property owner is refinancing the property, the tenant is going to be required to acknowledge that its lease interest is inferior to that of the first mortgagee. The following concepts need to be understood by commercial property managers.

Attornment: Attornment is a legal term dating back to early English Law in which a tenant of property was not automatically required to consent to a new landlord if there was a change in ownership. As such, there had to be an acknowledgement of the new landlord. The concept of "attornment" that was developed is the acknowledgement by a tenant to agree to be subservient to the rights of a new owner or landlord of the leased property. This is whether the tenant is the current tenant under the lease and there is a new mortgage, a refinance is being sought, or whether a tenant is signing a lease on the premises with an existing mortgagee in place. In either case, the tenant should always

be required by the commercial landlord to execute, as part of the lease, an attornment agreement in which the tenant effectively promises to recognize the mortgagee/lender (or a prospective mortgagee) as the tenant's landlord in the event of a default of the original landlord's mortgage obligation. An attornment protects a mortgagee who attempts to enforce his mortgage security from the risk of a tenant being released from their leases. As indicated, most commercial leases should be thoroughly drafted to include an attornment clause which would provide for the obligation by the commercial tenant to "attorn" to any successor in title which the lender might put in place through the exercise of the lender's remedy upon default and could include the lender or real estate owned entity of the lender.

Subordination: Subordination in commercial lease context means allowing for a third party to become superior to the real property interest being subordinated. In the case involving a commercial mortgagee on real property with a commercial tenant, in the event of a refinance, a mortgagee would require that the tenant subordinate its leasehold interest to the interest of the mortgagee. This is required so that in the event of any foreclosure, there could be no claim that the tenant would remain in occupancy. Normally the subordination is in effect to protect the lender in a strong market where the lender would want flexibility to terminate the lease and lease the premises to a prospective third party tenant for a higher rent or enable the property to be sold without a tenant in the premises. In the event of a refinance situation, all mortgagees will require that the tenant enter into an agreement in addition to the attornment agreement, to subordinate its leasehold interest to that of any new mortgagee.

In anticipation of these various and sundry provisions, again, a well drafted commercial lease should contain, among many other points, a subordination clause requiring the tenant to subordinate its interest to any new financing by a commercial lender.

Non-Disturbance Clauses: In situations involving attornment and subordination requirements the issue arises (especially with national tenants) that such tenant may not want to be dislodged in the event of a foreclosure, a refinance or any dispute existing between the landlord or its mortgagee or other parties.

For example, a national tenant having a long term lease with options to renew clearly does not want to have a successful location and operation with existing favorable lease rights, terminated as a result of a foreclosure action initiated by a mortgagee or the new lender exercising their rights to restructure the tenant mix or exercising their right to terminate certain of the leases. Sophisticated commercial tenants will want to have a corresponding right as to the subordination of their leasehold interest to avoid any risk of eviction.

The answer to such tenant's concerns is a non-disturbance agreement. A non-disturbance agreement creates a contractual relationship between the lender and the tenant in which the commercial landlord, as well as his mortgagee, indicates that neither the commercial landlord, its subsequent successor in interest nor the mortgagee or

subsequent mortgagee will disturb the tenant's possession so long as the tenant continues to pay rent and otherwise complies with the terms and conditions of the underlying commercial lease. This provides the adequate security and protection of a commercial tenant in its lease rights and is normally always insisted upon as a provision in a commercial lease by sophisticated commercial landlords.

The subordination, non-disturbance and attornment agreement (sometime referred to as "SNDA" in the industry) between the mortgagee and the tenant has the legal effect of creating privity of contract between both the tenant as well as the landlord through the mortgagee and the tenant. This relationship is also integral to the successful operation of not only the tenant's business, but projections required by the lender in performing the underlying the loan.

Most commercial mortgagees for commercial property will require a complete business analysis of the leases in effect and will look to protect those leases. Mortgagees want to make sure commercial leases, certainly at the very least those substantial tenants such as anchor tenants or national tenants which comprise core business of their property, have contained in the them appropriate SNDA's and supportive documentation.

Again, as the theme has been in all of commercial leasing, the right, duties and obligations of the Landlord and Tenant need to be well thought out prior to the lease being executed. The issues in regard to attornment, non-disturbance and subordination are all significant legal concepts which impact and affect the commercial landlord, commercial tenant and commercial mortgagee. Commercial landlords and commercial tenants need to grasp the significance of these various concepts and focus on such concepts at the time the initial lease is being negotiated and executed.