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NEGOTIATING NONDISTURBANCE AGREEMENTS

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**SUBORDINATION AND NONDISTURBANCE AGREEMENTS
THE TENANT'S PERSPECTIVE**

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600 SUBORDINATION AND NONDISTURBANCE AGREEMENTS

§6.1 Subordination - The Lender's Objectives. In making a loan secured by real property, a lender considers not only the appraised value of the land and buildings but will also carefully evaluate the existing leases which encumber that property and which will represent the primary income stream by which the loan will be repaid. As observed by two commentators:

“In structuring and documenting a loan, a lender will want to ensure that favorable leases (whether existing at closing or later executed) remain in place and unmodified throughout the term of the loan and continue in effect following foreclosure. The lender will also want to ensure that below-market or unduly burdensome leases do not survive foreclosure and that the lender's right to control condemnation awards and insurance proceeds is not undercut by an inconsistent lease provision that is senior in priority to the lender's deed of trust. On the other hand', in entering into a lease transaction, a tenant will want to ensure that its lease remains intact throughout its term and that the landlord's obligations are performed, even if the identity of the landlord changes over time. The tenant will be particularly concerned (at least in the beginning) that its lease and any subsequent amendments survive a foreclosure by its landlord's mortgagee-an event over which the tenant has no control.”¹

For the tenant, the consequences of a mortgage foreclosure could be disastrous. He faces the prospect of losing his lease or being permitted to remain only under terms and conditions dictated by the lender. The question of the survival of the lease upon a foreclosure will be determined by the relative priority of the mortgage lien and the lease. Absent an agreement to the contrary, those priorities will depend on the order in which the respective instruments were recorded or on whether a junior party otherwise had notice of the senior encumbrance. If the lease is recorded prior to the mortgage or the tenant is in possession at the time of recordation, or if the lender otherwise is, or should be, aware of the existence of the lease, the lease will be senior to the mortgage lien. Conversely, a lien will be senior to a lease if the mortgage is recorded before the recordation of the lease and before the tenant takes possession, or if the tenant has actual or imputed knowledge of the existence of the lien when it executes the lease.²

In modern leasing practice, the question of the subordination of the lease is almost universally resolved in the landlord's form of lease by the “automatic subordination clause”.

A typical form of automatic subordination clause follows:

Figure 6-1

Subordination of Lease

“This Lease and all rights of Tenant hereunder are and shall be subject and subordinate in all respects to (1) all present and future ground leases, operating

¹ Patricia J. Frobos and David S. Kitchen, *The Priority of Liens and Leases*, 15 Cal. Real Prop. J. 1 (Fall 1997) [hereinafter *Priority of Liens and Leases*]. Portions of the submitted materials have been reprinted with the permission of the authors. Ms. Frobos is the Chair of the Real Estate Department of O'Melveny & Myers LLP. Mr. Kitchen is a real estate attorney in the Los Angeles office of O'Melveny & Myers

² *Priority of Liens and Leases*, supra note 1, at p. 1.

leases, superior leases, overriding leases and underlying leases and grants of term of the land and buildings comprising the Shopping Center, or any portion thereof (collectively, the "Superior Lease"), (2) all mortgages, deeds of trust, deeds to secure debt and building loan agreements, including leasehold mortgages, and spreader and consolidation agreements, which may now or hereafter affect the land and buildings comprising the Shopping Center, or any portion thereof or the Superior Lease (collectively, the "Superior Mortgage"), and (3) each advance made or to be made under the Superior Mortgage. All references in this Lease to the Superior Lease and Superior Mortgage shall be deemed, in each instance, to include all replacements thereof, and any renewals, modifications, substitutions, supplements and extensions thereof or of any such replacement. "Superior Lessor" shall mean the lessor at the time of a Superior Lease. "Superior Mortgagee" shall mean the holder at the time of a Superior Mortgage. The provisions of this Paragraph shall be self-operative and no further instrument of subordination shall be required. In confirmation of such subordination, Tenant shall promptly execute and deliver, at its own cost and expense, an instrument, in recordable form if requested, that Landlord, the Superior Lessor or the Superior Mortgagee may reasonably request to evidence such subordination; and if Tenant fails to execute, acknowledge or deliver any such instrument within ten (10) days after request therefor, Tenant hereby irrevocably constitutes and appoints Landlord as Tenant's attorney-in-fact, coupled with an interest, to execute, acknowledge and deliver any such instruments for and on behalf of Tenant. Any Superior Mortgagee may, by giving notice of the same to the Tenant, elect that this Lease shall have priority over such Superior Mortgage, whether this Lease is dated prior to or subsequent to the date of such Superior Mortgage."

Under the foregoing provision, the superiority of a *previously existing* mortgage lien is simply confirmed since, as a matter of law this is already the case. With respect to *future* mortgages placed on the property after the lease was executed and which would otherwise be subordinate to the lease, the subordination clause reverses the priority of the two encumbrances in favor of the mortgage lien. Because this process places the tenant in a very dangerous position, it is essential for the tenant to secure its lease by reaching an agreement with the lender ensuring the survival of the lease upon foreclosure and the assumption by the foreclosing party (or the purchaser at a foreclosure sale) of the landlord's obligations. The "subordination and nondisturbance agreement" (or simply the "nondisturbance agreement" or "SNDA") achieves this result in return for which the tenant *confirms* (in the case of a previously existing mortgage) the inferiority of the lease to that mortgage and *subordinates* (in the case of a future loan) the leasehold interest to the subsequent mortgage. The manner in which, from a tenant's viewpoint, the nondisturbance agreement should be negotiated and drafted is extensively discussed in these materials (see ' ' 6.06-6.20 *infra*).

However, absent a tenant's ability to secure the promise of a nondisturbance agreement in its lease or to secure one upon direct request from the lender, it is important that, at the very least, the tenant understands the process by which lenders work their superior position to their greatest advantage.

The enforceability of automatic subordination clauses in California was tacitly confirmed in the case of *Dover Mobile Estates vs. Fiber Form Products*, extensively discussed below. The California

appellate court enforced the provision of the tenant's lease without discussion or analysis, despite the existing concerns of some commentators that such provisions were not enforceable.³

§6.2 Subordinating The Mortgage Lien To The Lease

Placing the lease *superior* to the mortgage gives the tenant the result he presumably always wanted but was unable to secure from the lender by means of an SNDA. However, since such alteration of priorities is the optional and unilateral choice of the lender, the protection the tenant receives is only fortuitous.

In Figure 6-1 and 6-2 the lender is given the option to elevate the lease at its election by giving notice to the tenant of such choice.

Figure 6-2

Subordination of Mortgage to Lease

Any Superior Mortgagee may, by giving notice of the same to the Tenant, elect that this Lease shall have priority over such Superior Mortgage, whether this Lease is dated prior to or subsequent to the date of such Superior Mortgage.

While this may appear beneficent on the lender's part, it is actually a very wise strategic option, as will be seen from the following discussion of a recent (1990) case in California.

In the case of *Dover Mobile Estates vs. Fiber Form Products*,⁴ a foreclosure purchaser brought an action to recover rent from a tenant who had been the lessee under a lease with the defaulting landlord. The mortgage lien had been created subsequent to the lease and would otherwise have been subordinate to it. However, the lease contained an automatic subordination clause which rendered the lease "subordinate to any mortgages or deeds of trust that may *hereinafter* be placed upon the premises." In addition, the lease provided that the mortgagee could elect to have the lease superior to the mortgage, whether the lease was dated or recorded before or after the mortgage. When the landlord defaulted under his mortgage loan, the mortgagee foreclosed and the property was sold in a trustee's sale. The tenant continued paying monthly rent for approximately six months and then after giving 30 days' notice, vacated the premises. The trial court found that the foreclosure sale extinguished the lease and entered judgment in favor of the tenant. The appellate court affirmed under the long-standing principle in California that the foreclosure of a superior mortgage extinguishes a subordinate lease, with the result that following foreclosure, neither the subordinate tenant nor the new owner is bound to perform under the lease. This result is automatic and is not dependant upon an election to do so by the mortgagee made *after* the foreclosure.⁵

In fact, the Court rejected the landlord's argument that the extinguishment of the lease is optional on the foreclosing purchaser's part following foreclosure, without any concurrence needed from the

³ *Priority of Liens and Leases, supra* note 1, at p. 4. The doubt stems from cases in California which require that in order for a lienor to be subordinated in status to a subsequent lien, the subordination clause must contain sufficient details disclosing the scope of the financial burden to which the lienor is being subordinated.

⁴ 220 Cal. App. 3d 1494 (1990) [hereinafter *Dover*].

⁵ This principle obtains in many other states as well.

tenant.⁶ The Court found “no reason to question the continued validity of this rule [i.e. automatic termination]” and observed that if the landlord's position were adopted:

“ . . . then the purchaser could evict the tenant if rent values increased or hold the tenant to the lease if rent values decreased. In other words, the purchaser could do whatever was most profitable. We decline to allow the purchaser this option. To the contrary, we think it more equitable to follow the rule that the trustee's sale automatically terminates the lease.”⁷

Although *Dover* confirmed long-standing law, it was greeted by tenants in the depressed commercial real estate climate of the early 1990's as an unexpected boon - a means by which they could escape out from under leases whose rents could not now be supported by business conditions. Indeed, it was felt by some tenants that they were better off not to be locked into their leases by a nondisturbance agreement with the lender. However, as observed in *Priority of Liens and Leases*:

“The outcome in *Dover* clearly favors tenants who find themselves burdened by above-market leases. In other economic circumstances, the *Dover* rule will please lenders or foreclosure sale purchasers who want to free their property of below-market leases. At the outset of a lease transaction, however, neither the lender nor the tenant will be able to predict whether the lease will be above or below market when the lender seeks to foreclose. Accordingly, unless the lender and tenant want to gamble on the future, it is in the best interests of both to enter into a subordination, nondisturbance, and attornment agreement that will preserve the lease following foreclosure,” (at p. 3).

Therefore, the perceived “boon” to the tenant does not really exist. A lender is able to retain its unilateral control of the situation (and avoid a countermove by the tenant) by electing to *subordinate the mortgage* to the lease prior to foreclosure, thereby preventing its extinguishment. Nothing in the *Dover* decision suggested that the lender could not do just that. The right to do so exists at common law (a party may simply decide to subordinate its interest in favor of another) and it may be contained in the loan documents. But regardless of whether and under what conditions this right may exist at law or the loan documents, the privilege is expressly preserved in the lease by the “election to subordinate” provisions noted above in Figure 6-2.

Thus, it is the *lender* who can play the circumstances to its best advantage, based upon the market conditions at the time of (but prior to) foreclosure. The lender's failure to do so prior to foreclosure in *Dover* was its fatal error.

Whether a tenant's lease is subordinate to the mortgage because it was executed after it or was rendered subordinate to it by an automatic subordination clause, it appears that a tenant cannot prevent a lender from subordinating *its* mortgage lien *prior* to foreclosure regardless of what the lease says. Thus, there is little a tenant can do to avoid being manipulated by the lender following a loan default unless the tenant (1) was able to negotiate a nondisturbance agreement with the lender prior thereto, or (2) is otherwise able to level the playing field at the time of foreclosure.

⁶ The key phrase here is “following foreclosure.” The lender had failed to subordinate the mortgage to the lease prior to foreclosure (as he had the right to do) but argued for the proposition that an automatic extinguishment was inconsistent with modern-day real property transactions.

⁷ *Dover* at 1500. See also *Priority of Liens and Leases*, *supra* note 1, at p. 3.

For a tenant without nondisturbance protection from a superior lender, there may still be two factors that afford some strategic benefit:

- (a) when a lender elects to elevate the lease superior to the mortgage, he takes the lease as he finds it, with all of its provisions including those which the lender might otherwise find objectionable. Thus, provisions in the lease that the tenant negotiated for its protection e.g. provisions governing the rights of the parties following a destruction or condemnation of the premises which are less favorable to the lender than the provisions of his loan documents - will be binding on the lender. This may induce the lender to enter into negotiations with the tenant for a nondisturbance agreement in order to secure lease provisions more acceptable to him;
- (b) during the lease negotiation the tenant might attempt to obtain from the *landlord* a clause that provides that if the existing lender fails to execute a nondisturbance agreement with the tenant within a specified period of time, then tenant shall have the option at the time of foreclosure (as distinguished from the time that an SNDA is refused), to terminate the lease whether or not the lender ultimately elects to elevate the lease at that time.

The Lender's Election - All or Nothing. One large commercial lender had until recently ubiquitously employed the “Subordination of Mortgage” device at or near the time of lease execution (i.e. of a subordinate lease) to preserve that lease in the event foreclosure became necessary in the future.⁸ However, that lender's form carves out from the operation of the mortgage subordination the damage and destruction, insurance and condemnation provisions of the mortgage. In other words, the lender is attempting to subordinate the mortgage to the lease except for selected provisions of the mortgage which would continue to remain superior to corresponding provisions of the lease. It is highly doubtful, however, that this selective subordination tactic will work. The generally prevailing view is that if the lender elects to elevate the lease above the mortgage, he must elevate the whole lease and not just those provisions he likes. Therefore, an attempted “partial” subordination may be invalid with the result that the lease would be extinguished by the foreclosure anyway, just the opposite of the lender's intent. And, depending on the market conditions at the time, this may be a welcome result for the tenant as it was for the tenant in the *Dover* case.

The insurance and damage and destruction provisions of the lease are often extensively negotiated by the tenant⁹ and leases frequently grant rights to the tenant and impose obligations upon the landlord more favorable to the tenant than the provisions of the mortgage between the landlord and the lender. In a multi-tenanted property such as a shopping center, the lender can find himself burdened with wholly inconsistent provisions and obligations scattered throughout numerous leases governing damage and destruction and the disposition of insurance proceeds, all of which will be very troublesome in the face of the real hazards of fire, earthquake or hurricanes.

⁸ Once the lender had decided that it would probably want the lease to survive foreclosure (and it reached that decision early in the process), it preferred the use of this device rather than negotiating a nondisturbance agreement.

⁹ This is less true in the case of the eminent domain provisions unless the tenant is an out-parcel occupant or a large space user (in which case a nondisturbance agreement would be forthcoming anyway).

A lender not wishing to find itself in this position may be persuaded to negotiate a nondisturbance agreement with the tenant in order to preserve the desired insurance and damage and destruction provisions of the mortgage.

Leveling The Playing Field. The ability of the lender to unilaterally subordinate its mortgage lien to the inferior lease gives him an unfair advantage over the tenant, enabling the lender to terminate a lease or preserve it depending upon the rental market at the time, with the result that a potentially profitable business and a huge investment by the tenant in leasehold improvements in the premises will be wiped out. In the words of the *Dover* court: “the purchaser could do whatever was most profitable”.¹⁰

If the lender wishes to play the market at the tenant's risk, then the tenant should have a reciprocal right. The tenant should attempt to secure a clause from the landlord which provides that in the event that the superior lender fails to execute a mutually acceptable nondisturbance agreement with the tenant within as specified period of time, with each party acting in good faith, then the tenant shall have the right to terminate the lease upon a foreclosure of the mortgage and whether or not the lender has elected to subordinate the mortgage to the lease.¹¹ The effect of this clause would render the question of whether the lease survives foreclosure a *mutual* decision of the lender and the tenant. Each party would be free to pursue whatever “was most profitable”. If that coincided with the interests of the other party, then everyone is satisfied with the result. If one party attempts to press for an improvement of his position, the other party is not required to agree. In other words, the parties are free to negotiate (or not negotiate) a new deal. For the lender, this means approaching the tenant to learn of his inclinations prior to foreclosure for that is when the lender must decide whether to subordinate or not.

The purpose of this approach is to strongly encourage the lender and the tenant to enter into a nondisturbance agreement when the lease is being signed so that neither party is put at risk by what the prevailing market conditions are at the time of the loan default.

There are problems with this approach. A landlord who can successfully resist the tenant's request for a nondisturbance agreement from the existing lender or conditional subordination from a future lender will be extremely resistant to a provision which might be even more objectionable to his existing lender; and if the landlord submits the lease to the lender prior to the landlord signing it, the clause could very likely not survive the negotiation.¹² On the other hand, the parties have often agreed, in the case of an existing lender, to include a clause in the lease that if such lender refuses to grant an SNDA within a specified period of time after lease execution (e.g. sixty days), then the tenant would have a right to terminate the lease *at that time*. It can be assumed that the lender is aware of this provision since

¹⁰ *Dover* at 1500.

¹¹ What an “acceptable” nondisturbance agreement, negotiated in good faith, would look like is admittedly a wide open question. The subsequent sections in these materials which deal with the actual negotiation of the SNDA may provide helpful suggestions and practice tips to aid both lender's and tenant's counsel.

¹² It is not completely unheard of that a landlord has failed to consult with the existing lender prior to executing a lease. However, absent any bad faith collusion on the tenant's part, such a provision should be enforceable upon foreclosure and the lender's succession to the landlord's position just as would any other cancellation provision freely negotiated into the lease. [It is assumed, of course, that the lender elevated the lease above the mortgage prior to foreclosure and is seeking to enforce it against the tenant.] Since the lender did not rely on subsequent non-existent leases when he made his loan, the inclusion of this provision is no different than any other cancellation provision negotiated by the tenant for its protection. The tenant has no duty to see to it that the landlord complies with its obligations under the mortgage to obtain the lender's approval prior to signing subsequent leases.

lenders often insist that they review the lease they are being requested to recognize. Sometimes a tenant is successful in getting an SNDA, sometimes not, but in either case the reaction of the lender has rarely been hostile over the presence of such a termination right. Analogously, one would expect that lender would not overly react to a similar provision which pushes the tenant's right to cancel to some uncertain future time the event of foreclosure, even if it is a time when a lender's sensitivity is heightened.

The provision may supply the incentive for the lender and the tenant to make their peace now and to agree that the lease will be honored as written,¹³ and avoid gambling on the future. If the lender fails to execute a nondisturbance agreement within the allotted time period but elects at the time of foreclosure to subordinate the mortgage to the lease anyway, he will argue that the tenant has received the functional equivalent of a nondisturbance agreement and therefore the termination right should in all fairness be nullified. However, the lender's action merely places the parties back in the *status quo ante*, where the lender unfairly enjoyed the unilateral right to decide whether to preserve the lease. If the tenant no longer wishes to remain in the premises, he should retain his bargained-for right to terminate.¹⁴ The tenant would have been willing to bargain away that right at the outset if the lender had been willing to grant nondisturbance protection. This termination right is the functional equivalent of the tenant negotiating an option to extend the lease - a purely volitional decision which is driven by business conditions at the time. The only difference is that with a termination right, the moment in which the tenant must decide whether to end his lease obligations will come upon him suddenly.

The termination right, therefore, places the parties in equilibrium in a situation where a tenant, who is honoring its lease obligations, would otherwise face a serious risk of the loss of its business and investment because the lender is demanding more rent or wishes to make a more favorable use of the property. To avoid a situation where the parties are pointing pistols at one another in the manner of 19th Century duelists, a negotiated nondisturbance agreement is the appropriate solution.

With respect to a *future* lender the operation of this clause may be more dramatic. If the tenant is unable in its lease negotiations with the landlord to condition the tenant's subordination upon receiving nondisturbance protection in return, then it would seem even more difficult to get the landlord to agree to a clause such as this because the landlord would expect that a lender would find it more objectionable than granting an SNDA. Which is the very objective of the tenant's approach - to either convince the landlord to insert a conditional subordination clause (which guarantees the tenant a nondisturbance agreement from the moment of lease execution) or to convince a lender later on to grant one. A future lender will be far more motivated to enter into a nondisturbance agreement which will guarantee the flow of the rent payments when the lender will need them most.

§6.02-A. Another Tenant Protection - Curing The Landlord's Default. There is another method available to the tenant who was unable to secure nondisturbance protection from an existing lender or to convince the landlord to grant the termination right discussed in ' 6.02. The landlord can grant the tenant the right to cure the landlord's default under the mortgage with the companion right to recover reimbursement from the landlord for the amount expended to cure. However, in order for this remedy to be effective it will also be necessary to secure the lender's agreement to accept the cure tendered by the tenant (for the lender is not otherwise obligated to do so). The lender should have little objection to this procedure as it would be more palatable than granting a nondisturbance agreement or being pressured into subordinating his mortgage lien prematurely. The only situation in which the lender would resist this

¹³ Or with any changes requested by the lender that the tenant may agree to.

¹⁴ If a tenant was in default under the lease at the time, he would be disqualified from exercising this right.

approach would be if it desired to get out of the loan altogether for a variety of reasons (such as rising interest rates).

Section 2924.b of the California Civil Code provides a procedure whereby certain parties in interest may be entitled to receive copies of a Notice of Default filed by the lender. A party entitled to receive such notice is granted a statutory right to cure the landlord's default and acquires a right of reimbursement from the landlord for the sums so expended. This idea is also supported by *Priority of Liens and Leases*.¹⁵

While the tenant may not be enthusiastic about the prospect of resurrecting defaulted mortgages it is a way out of his dilemma. This procedure would be unduly burdensome to a shopping center tenant but in the case of a street deal where the amount of the delinquent performance is not very great, this may be a workable solution for the tenant.

§6.3 Non-Disturbance Protection. The above discussion explored the options available to a tenant who does *not* initially have the stature to condition the deal on getting an SNDA from an existing lender or to require the landlord to guarantee nondisturbance protection for the tenant from a future lender in return for the subordination of the lease to the future mortgage. In the Sections that follow, we shall examine the concept of conditional subordination on the assumption that the tenant has sufficient importance to demand it from the landlord. Although its possible that a tenant with clout may still not be able to convince an *existing* lender to grant nondisturbance protection to him, his relationship to a *future* lender is quite different.

A. Future Mortgages. With respect to future mortgages the tenant must demand that its obligation to subordinate be expressly conditioned upon receiving written assurance of non-disturbance protection from the lender should the landlord default under his mortgage (“conditional subordination”). The tenant has made its deal, signed the lease guaranteeing him possession for the stated term and at the stated rents and has expended considerable sums in reliance thereon to improve the store. It is fundamentally unfair that he be dispossessed because of the landlord's default when the tenant himself has been faithfully observing the terms of the lease. Any tenant, regardless of whether its lease is a credit lease, is entitled to enjoy the sanctity of continued possession and to attorn to the foreclosing lender as his new landlord. This is especially true where the mortgage was executed after the tenant signed its lease and where the tenant was relegated to a subordinate status by virtue of an automatic subordination clause.

For a *credit tenant*, it constitutes the crowning irony to have its lease counted as a credit lease on the one hand - entitling the landlord to derive the benefits of a loan and allowing the lender to enjoy the security of the tenant's financial strength - and on the other hand to permit the tenant to be dispossessed and his huge investment forfeited at the whim of that lender whose own interest may have been created after that of the tenant.

Many landlords assert that the smaller, non-credit tenant is not entitled to this protection, reserving it only for the large national chains. This undervalues and belittles the small tenant, especially in the case of a shopping center. The landlord was anxious enough to have that tenant in the mall in the first instance to fill up those empty spaces and to add synergy to the shopping center. In addition, it is far more burdensome for a smaller tenant to make the investment necessary to build out a store, stock it and assume inherently greater risks than it is for the large, wealthy chains. It is the duty of both the landlord and the lender to respect every tenant and his lease, provided that such lease is in good standing.

¹⁵ *Priority of Liens and Leases*, *supra* note 1, at p. 13.

Built-In Nondisturbance Protection. There are a minority of shopping center developers in this country who support this principle and build non-disturbance protection (i.e. conditional subordination) right into their printed lease form. By and large however, tenants, including the national chain credit tenants, must still endure the burden of negotiating this protection into the lease on every occasion. Resistance from landlords' lawyers still exists. The landlord's lawyer, for his part, is trying to make it easy on his client when closing a loan in the future and will be arguing for a lender that does not then exist when, in many cases, a future lender will accept the existing tenant, his lease and nondisturbance form¹⁶ as a *fait accompli*. Experience has shown that a lender will be far more reasonable when dealing with an existing tenant (with respect to whom the lender desires to acquire priority) than with respect to a tenant who is already subordinate by virtue of having signed a lease after the loan was recorded.

Landlord's Arguments Against Conditional Subordination

In negotiating with the landlord's lawyer, numerous arguments have been advanced to dissuade the tenant from insisting upon conditional subordination.

"I'll Never Get a Loan!" Some landlord lawyers have argued that to impose this condition in the subordination clause will endanger the landlord's ability to get financing. They scare their clients with this advice which makes it that much more difficult to get over the issue given the backdrop of a traditional fear of bankers. However, this is simply not borne out in the real world. Lenders are in the business of closing loans and no lender - certainly not one intending to loan out \$50 or \$100 million on a shopping center property - is going walk away from a deal because one of the satellite tenants, and a credit one at that, is insisting on nondisturbance protection in return for the subordination of the lease. If there are lenders out there with that disposition and the landlord's lender unfortunately turns out to be one of them, the risk, such as it is, will have to assumed by the landlord, not the tenant.

"Don't Worry About It!" Other landlord lawyers argue with a different slant: "A credit tenant like yourself shouldn't worry about and insist on a nondisturbance agreement because no lender in its right mind would ever terminate your lease upon foreclosure since in such a distress situation the lender will want good rent paying tenants in place." Then the obvious answer here is that such lender will have no problem giving the tenant nondisturbance protection at the outset. In other words, the landlord's argument is true, until its not. If there is a foreclosure, there is simply no guarantee that lenders will act in this fashion. They may want to amend the lease to their liking, with termination as the ultimate threat. In the New York City market lenders are interested in vacant possession and will want to foreclose to the ground, regardless of who the tenant is, for no other reason than a rising rental market. Or, the purchaser at foreclosure may have different development plans for the building. He may wish to install an even more desirable tenant in the space or he may want to demolish the building altogether and redevelop property in another way. Without nondisturbance protection a tenant is in serious jeopardy.

"I'll Indemnify You!" This is an interesting solution proposed by the landlord. The suggestion here is that if there is a foreclosure and the tenant's lease is terminated by the lender, the landlord will indemnify the tenant for his loss. To persons of ordinary intelligence one immediately realizes that if the landlord has defaulted under his loan and has precipitated a foreclosure, his obligation of indemnity is of no value. Furthermore, most leases contain an "exculpation" clause or a "non-recourse" clause which limits tenant's recovery source for monetary claims to the landlord's "interest in the Shopping Center". Following a foreclosure, the landlord no longer has an interest in the real estate so there is no one or no recovery source to pursue. For this scheme to work a landlord would have to guarantee a huge obligation

¹⁶ Prudent leasing practice in this area suggests that the tenant attach a nondisturbance form that he is comfortable with that he will agree to sign with a future lender.

personally including loss of future sales and profits, the cost of leasehold improvements - and put up significant assets to secure it; this will never happen.

“You Can Terminate The Lease!”. As noted under ' 6.02 above, some lawyers suggest that if, at the time of closing the loan, the future lender refuses to sign a nondisturbance agreement, the tenant will have the right to cancel the lease! The defect in this argument should be obvious. If nondisturbance protection and quiet possession, i.e. the ability *to remain* in the Premises following a mortgage foreclosure is what the tenant is looking for, then why would he want the right to *cancel* the lease, especially at the very moment of the loan closing, long before there is even an issue of a landlord default and mortgage foreclosure and indeed which issue may never even arise? The tenants business may be doing very well at the time and he would have no desire to terminate the lease. Such a clause would force the tenant to make a dramatic decision at the time of the closing of a future loan when termination may be the furthest thing from his mind. What the tenant is seeking is not a cancellation right but quiet enjoyment of the premises and the preservation of his lease.

[In ' 6.02, an approach was discussed whereby in the event a *prior* superior lender failed to negotiate a non-disturbance agreement within a period of time, the tenant would have the right, at the time of foreclosure to terminate the lease, whether or not the lender exercised his right to unilaterally subordinate the mortgage in order to preserve the lease upon foreclosure. Such a solution was designed to place both the lender and the tenant on a level playing field, each party taking the risk that the other might cancel, thereby forcing them to conclude a non-disturbance agreement well in advance of a possible foreclosure. The only way the clause was truly effective is where the tenant could terminate the lease at foreclosure time regardless of what the lender decided to do regarding the status of the lease. However, as against a *future* lender who is seeking to achieve priority by virtue of an automatic subordination clause, this approach is a sorry substitute for nondisturbance protection].

Accordingly and despite the above proffered landlord arguments, the subordination provision of the lease must condition the tenant's subordination upon getting nondisturbance protection from the lender.

Figure 6-3

Subordination Conditioned Upon Nondisturbance Protection

“Non-Disturbance Protection From Future Encumbrance Holder. This Lease shall not become subordinate to the lien of any mortgage, deed of trust, ground or master lease, sale-leaseback transaction or other security instrument (any one or more of the foregoing individually or collectively called an “Encumbrance”) which shall hereafter be placed on the Premises, unless and until Landlord obtains from the holder of the Encumbrance placed against the Premises, a non-disturbance agreement in recordable form which provides that in the event of any foreclosure, sale under a power of sale, ground or master lease termination or transfer in lieu of any of the foregoing or the exercise of any other remedy pursuant to any such Encumbrance (a) Tenant's use, possession and enjoyment of the Premises shall not be disturbed and this Lease shall continue in full force and effect so long as Tenant is not in default hereunder, and (b) this Lease shall automatically and unconditionally become a direct lease between any successor to Landlord's interest, as landlord, and Tenant as if such successor were the Landlord originally named hereunder.”

DRAFTING POINT → Conditional Subordination- Tenant's Subordination Must Be Conditioned Upon Nondisturbance Protection. Some leases contain the provision that **“this Lease will continue notwithstanding a foreclosure of the mortgage”**. This has no effect on a pre-existing lender. The lender is not a party to the lease and by virtue of its superior lien, is not subject to the terms of the lease.¹⁷ Furthermore, if the clause obligates the tenant to subordinate to a future lender in one sentence and in a separate sentence declares that the lease will continue notwithstanding foreclosure, it is highly doubtful that, without the interdependency of the two sentences, this language would be sufficient to protect the tenant. The lender, as a third party beneficiary, enjoys the benefit of the tenant’s covenant in the lease to subordinate but arguably would not have the obligation to honor the nondisturbance provisions of the clause. In the words of the commentators:

“A tenant should not accept the “wooden nickel” lease provision that purportedly obligates any purchaser at a foreclosure sale to recognize and not disturb the tenant. The provision probably would be binding on a junior lienholder (who would take subject to the lease anyway) but would not bind a senior lienholder. Under *Dover*, a foreclosure sale purchaser will not be bound by any provision of the [subordinated] lease, and that presumably includes a provision of the lease purportedly obligating the purchaser to recognize the lease.”¹⁸

Unless the tenant's obligation to subordinate is directly and expressly conditioned upon getting a non-disturbance agreement, he is not really protected.

Subordination of The Mortgage to The Lease. This was extensively discussed in Section 6.01 supra. However if the lender has already decided to preserve the lease and elects this method at the time the lease is executed (in the case of a subsequent lease) or at the time of loan closing (in the case of a preexisting lease with an automatic subordination clause in it) there are numerous advantages to both tenant and lender, as follows:

1. lease is preserved automatically upon a foreclosure and no one has to think about it. The lender is relieved of the concern that he may have failed to timely subordinate the mortgage with the unhappy result that the desired lease is inadvertently extinguished (as in *Dover*). The lender or the tenant would then be the vulnerable party, depending upon market conditions. By contrast, using the subordination of lease and non-disturbance approach may require the parties to sign yet another document to reaffirm their relationship with one another - i.e. execute a novation - despite language in the non-disturbance agreement which recites that further documentation is unnecessary. This may be particularly true in jurisdictions like California where foreclosure automatically extinguishes the lease as a matter of law;
2. the document is extremely short and requires no negotiation on the part of the tenant. There are no unreasonable provisions which often are found in modern SNDA forms nor generally any limitations upon the lender's obligation. However, in the case where this device is used, a

¹⁷ *Priority of Liens and Leases, supra* note 1, at p. 4.

¹⁸ *Priority of Liens and Leases, supra* note 1, at pp. 13.

typical subordination of mortgage form will nevertheless attempt to exclude from the effects of subordination the following:

- a. those portions of the mortgage which deal with casualties and the release of insurance proceeds, all of which remain superior to the lease. In a shopping center lease, this is a scenario that tenants will generally accept. [But see ' 6.19 *infra* in the case of street deals and strip center deals.]
- b. those portions of the mortgage which deal with eminent domain and the release of condemnation awards, all of which remain superior to the lease. Again, in a shopping center lease, tenants will generally accept this. [But see ' 6.20 *infra* in the case of street deals and strip center deals.]
- c. any liens which have intervened between the time the mortgage was signed and the time the lease was executed.

Although “selective” subordination is not enforceable (see discussion under ' 6.02 *supra*), most tenants will agree to the carved-out exceptions in return for the peace of mind that their lease will survive foreclosure. Such forms generally provide a place for the tenant to sign as confirmation of the tenant's agreement to the carved-out provisions. This “selective” subordination procedure is more acceptable in malls, less so in strip centers and street deals.

§6.4 Attornment by Tenant. The printed attornment clauses appearing in leases are written on the assumption that the subordination clause is also unchanged, i.e. that the tenant is subordinate to present and future mortgages without non-disturbance protection. Thus, these attornment clauses provide that while the tenant is obligated to attorn to the foreclosing lender or purchaser at foreclosure sale, such party may accept the tenant's attornment merely at its option. These clauses need only to be changed to be consistent with the lender's obligation to recognize the lease and become the new landlord under it.¹⁹

Figure 6-4 below is an extract from an actual lease. The portions relevant to this discussion have been underlined. Figure 6-5 denotes the necessary changes.

Figure 6-4

Attornment by Tenant (Original Version)

“In the event any proceedings are brought for foreclosure, or in the event of the exercise of the power of sale under any mortgage, deed of trust or deed to secure debt made by Landlord covering the Premises, Tenant shall at the option of such purchaser attorn to the purchaser upon any such foreclosure or sale and recognize such purchaser as the Landlord under this Lease.” (Emphasis added).

¹⁹ See *Priority of Liens and Leases*, *supra* note 1, at pp. 7-8 for a discussion of a case where, after a foreclosure, a subordinate lease was nevertheless preserved by virtue of the operation of the attornment provisions of the lease.

Figure 6-5

Attornment by Tenant (Revised)

“In the event any proceedings are brought for foreclosure, or in the event of the exercise of the power of sale under any mortgage, deed

In the case of a total condemnation the lease automatically terminates and the only residual question is the apportionment of damages.

³² Its difficult to understand how such damages could reduce the landlord's award if they are truly specifically awarded to the tenant. Even if a court makes one award for the total amount of all property interests taken and the damage suffered by both landlord and tenant, does the answer turn on whether the award is embodied in a one party check (i.e. where the landlord is the sole payee) or a two-party check?

³³ I.e. the bricks and mortar, the rent stream, the value of the reversion, the value of the leasehold estate as well as the special tenant damages.

applicable to the Building and Leasehold Improvements (as defined in Article 6 of the Lease) as shall be necessary for the purposes of restoration consistent with Landlord's and Tenant's rights and obligations under Article 13 provided that Landlord observes the requirements set forth in the Mortgage for the release of condemnation awards ("Release Requirements"). Notwithstanding the foregoing, and so long as the Tenant under the Lease is Y, Inc., or an Affiliate of Y, Inc., Tenant shall not be required, as a condition precedent to the release of any condemnation awards hereunder, (a) to furnish waivers of liens from any contractor, subcontractor or materialman performing such restoration work other than Tenant's general contractor, or (b) to furnish a payment or performance bond in connection with such restoration work, notwithstanding anything to the contrary contained in the Release Requirements;

- (ii) whether or not the Lease is terminated by reason thereof, Mortgagee releases its interest in that portion of the award to which Tenant is entitled pursuant to Article 13 of the Lease."