

Legal

Avoid subordination agreement misunderstandings

It is important for tenants to understand their rights and remedies in the event that a commercial property is foreclosed on. The foreclosure process can be confusing to navigate even for the most sophisticated of parties. Unfortunately, it can be difficult for a tenant to ascertain the financial strength of a landlord at the outset of a lease. The subordination agreement really is a tenant's best form of protection on that front. From a tenant perspective, a subordination agreement would be most critical in cases where the tenant intended to expend significant funds and resources on tenant improvements or the tenant was executing a long-term lease at below-market rates. It's also important to remember that in negotiation, if you don't ask for a subordination agreement, you most definitely will not be provided one!

In almost every lease, there is a provision that places the lender in a first and prior lien on the property. In other words, the lender wants its deed of trust to be superior to all other interests, including those of the tenant.

Here are a few questions and answers that should clear up any misunderstandings with tenants, owners, lenders and property managers.

• **Sessions:** Can a lender really extinguish the tenant's lease in a foreclosure?

• **Halstead:** Absolutely. Both commercial leases and deeds of trust typically include language confirming that the leases are subordinate to the interest of a lender holding a security interest in the leased property. The lender typically wants to have the option to foreclose out leases that might be



Steven S. Sessions
CEO, Sessions
Group LLC

below market or have a negative impact on the value of the property.

• **Sessions:** What can tenants do to protect themselves from a lease termination and survive a foreclosure from the lender, or any other successor landlord?

• **Halstead:** In an ideal world, a ten-

ant will want to have a nondisturbance agreement in place with the lender. In other words, an agreement by the lender not to foreclose out the tenant's leasehold interest. These types of agreements typically are conditioned on the tenant not being in default under the lease. I say "in an ideal world" because lender's often are reluctant to provide subordination agreements or are nonresponsive to requests for a nondisturbance agreement. Often, nondisturbance agreements are only available to national tenants or tenants with strong financials, leasing at market or above-market rates.

• **Sessions:** When does a subordination occur?

• **Halstead:** A wise tenant will request a subordination agreement before lease execution, when the tenant still has some leverage. In other cases, the tenant may have a termination right if the subordination agreement is not obtained by the landlord within a certain timeframe following lease execution. Landlords should be cautious about agreeing to obtain subordination agreements for their



Amanda H. Halstead
Member, Mills,
Schmitz, Halstead,
Zaloudek LLC

tenants. After all, a landlord often has little or no control over its lenders. As a landlord, I might limit my commitment to the tenant to undertaking "reasonable effort" to obtain a subordination agreement in favor of the tenant, an agreement to undertake "best efforts" puts an even higher burden on the landlord. It's also important to note that some lenders may assess fees to the landlord for reviewing and/or negotiating a subordination agreement.

• **Sessions:** Does a lender prescribe certain clauses that must be included in the lease agreement?

• **Halstead:** Lenders typically like to see provisions confirming that the lease is subordinate to their interest, requiring the tenant to execute amendments to the lease at the lender's request provided that there is no change in material business terms, requiring that the lender be provided notice and an opportunity to cure in the event of a landlord default, and setting forth with particularity the parties respective insurance requirements and that the same can be modified if reasonably requested by the lender.

• **Sessions:** Do most lenders have their own subordination, nondisturbance and attornment agreements?

• **Halstead:** Yes. It's usually best to start with the lender's SNDA form to avoid unnecessary costs in

review and negotiation.

• **Sessions:** How often have you seen a lender foreclose on a property and evict the tenant from the space?

• **Halstead:** It's rare. That said, it's more common with a single-occupant property that might be most attractive to an end user. Also, it is a legitimate concern of certain "discount retailers" who often have under-market leases.

• **Sessions:** In a foreclosure, which entity does the tenant pay their rent to?

• **Halstead:** I have to give you the typical attorney response ... "It depends." Technically, the landlord is the owner until such time as the foreclosure has been completed. That said, a lender may exercise its rights under a collateral lease assignment agreement, which allows the lender to directly collect the rents in the event of a default by the landlord. Typically, a tenant would receive written notice from the lender indicating that it is exercising such rights.

• **Sessions:** Should tenants be concerned with the return of their security deposit in the case of a foreclosure? How can a tenant protect one's security deposit?

• **Halstead:** Commercial leases usually include a provision that a successor owner is liable for the return of the deposit only to the extent received by it. A successor owner will not want to have liability for funds never received by it. This could have a chilling effect on the foreclosure sale, resulting in lower bid prices. Unfortunately, in most cases, following a foreclosure, a tenant's remedy for failure to return a security deposit will be limited to a claim against the prior, defaulting owner. ▲