Reviewing Subordination and Nondisturbance Agreements from the Tenant's Perspective

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Your tenant's NDA or SNDA might not provide all of the protection that the tenant needs. Following the steps in this article can help you to find out if that's the case and to propose stronger protections.

WHEN REVIEWING a nondisturbance agreement (NDA) or a subordination, nondisturbance, and attornment agreement (SNDA) it is important to keep in mind that state laws vary significantly with respect to the impact of a foreclosure on interests (including leases) that are junior to the foreclosing interest (typically a mortgage). In some states, the foreclosure automatically extinguishes all junior interests, in the absence of an agreement between the foreclosing entity and any individual applicable junior interests. Many states use what is sometimes referred to as the "pick and choose" rule that allows the foreclosing entity to decide which, if any, of the junior interests will survive a foreclosure. Finally, other states provide tenants in possession with limited protections in the event of the foreclosure by a senior interest. In any situation, the best approach from a tenant's perspective is to assume that, in the absence of affirmative recognition and nondisturbance protection that, a foreclosure may result in the extinguishment of the lease or important rights under the lease, at the lender's option. Thus, in situations where the tenant might otherwise welcome the lease being extinguished by foreclosure (e.g., rent at above market rates),

the lender can require the tenant to remain in place. Conversely, where the tenant has an advantageous lease, the lender might elect to extinguish the lease in the foreclosure or, use the threat of such extinguishment to extract concessions from the tenant (e.g., higher rent).

Below are basic steps to consider when reviewing an NDA or an SNDA from a tenant's perspective. NDAs are typically a document that is executed at the beginning of the lease, often as a tenant contingency, where the lease is naturally junior in priority to an existing mortgage or deed of trust. SNDAs typically arise in the context of an existing lease, where there will be a new or modified mortgage or deed of trust on the property that would otherwise be naturally junior in priority and subject to the lease. Most frequently, the initial form for an NDA or SNDA will be generated by the landlord's lender or potential lender. Some, but not many, leases will include an agreed upon form NDA and/or SNDA as an exhibit to the lease, although lenders and buyers often ignore the agreed upon form from the lease if it is not that lender's standard form, and instead will submit their preferred standard form to the tenant instead of the form attached to the lease.

STEP ONE • Upon receipt of a proposed SNDA or NDA, it is good practice to first check the underlying lease to determine precisely what obligations, if any, the tenant has with respect to subordination. Leases typically specify a required turnaround time for the tenant to respond to and execute the SNDA or NDA. Many leases also specify what the lender may include in the SNDA or NDA, including required waivers by the tenant of some of its rights under the lease if the lender or another party acquires the property through a foreclosure or deed in lieu of foreclosure. Occasionally, the lease will include an exemplar of the SNDA or NDA as a lease exhibit. In those circumstances the SNDA or NDA is typically the standard form for such document in then in use by the landlord's existing lender at the time of the lease. Note that many lenders often provide a form that is substantially favorable to the lender, going well beyond what the tenant is required to provide to the lender under the lease, in an attempt to shift as much of the underwriting risk as possible related to a landlord/borrower default from the lender to the tenant.

STEP TWO • The SNDA or NDA will typically include a specific reference to the document(s) that constitute the lease. Someone familiar with the lease needs to confirm that the description of the "lease" used in the SNDA or NDA is correct and includes all addenda and amendments (including any relevant side letters or agreements).

STEP THREE • While most SNDAs and NDAs focus on the substance and mechanics of subordination, recognition, and nondisturbance, some lenders will also include estoppel language for the tenant in the SNDA or NDA, rather than require a separate estoppel certificate in connection with the SNDA or NDA. To the extent that an SNDA or NDA includes estoppel provisions, those provisions should be reviewed and revised in the same manner as a stand-alone estoppel certificate, a subject covered in the May, 2014 issue of The Practical Real Estate Lawyer.

STEP FOUR • As long as the SNDA or NDA includes appropriate and adequate recognition and nondisturbance protections, the subordination component of the SNDA or NDA is typically noncontroversial. Expect that the document will include language requiring the tenant to subordinate its interest under its lease to the lender's mortgage or deed of trust, including any future advances or modifications of that mortgage or deed of trust.

STEP FIVE • There are several important elements to the recognition and nondisturbance components of the SNDA or NDA. First, the tenant's obligation

to subordinate its lease to the lender's mortgage or deed of trust needs to be expressly conditioned upon the lender's agreement to recognize the lease and not disturb the tenant's occupancy under the lease in the event of a foreclosure or deed in lieu of foreclosure. Second, most lender-generated SNDAs or NDAs will condition the lender's obligations to recognize the lease and not disturb the tenancy upon the tenant being in "full compliance" with the lease. While the general concept of conditional recognition and nondisturbance is reasonable, the condition should be "tenant not being in default under the lease beyond the applicable cure period." Third, when possible, the tenant should obtain an assurance from the lender that the tenant will not be joined as a party in any foreclosure action, except where the tenant is a necessary party. This will save the tenant unnecessary attorneys' fees incurred in participating in any foreclosure action that ultimately will not affect its tenancy.

STEP SIX • In addition to conditioning recognition and nondisturbance protection upon tenant's default status under the lease, almost every SNDA or NDA will include significant limitations on the obligations of the lender (or any purchaser at a foreclosure sale), in the event such party comes into possession of the property that includes the premises. Below is a list of common limitations requested by lenders, along with comments on each from a tenant's perspective.

Lender Will Not Be Liable for Any Act or Omission of Any Prior Landlord

Unless included as a provision expressly required under the lease, this item should be deleted. A tenant does not want to be in a position where the landlord fails to perform under the lease or otherwise harms the tenant and then, following the foreclosure, the tenant has no recourse against the new landlord and the tenant is left only with its claim against the foreclosed out landlord, who is likely judgment proof. If the lender's primary concern is not having to pay additional funds to cure an existing landlord default, one potential compromise is for the tenant to agree to limit its remedies with respect to any default of a prior landlord to offset rights, often with a cap as a percentage of the base rent (e.g., tenant can offset up to fifty percent of the base rent per month to cover tenant's damages from a prior landlord's default).

Lender Will Not Be Subject to Any Offsets or Defenses that Tenant Might Have Against any Prior Landlord

Similar to the item immediately above, this provision should be deleted unless expressly required by the lease. Note that these first two types of waivers sought by lenders reflect the landlord's desire to shift some of its risk related to a borrower / landlord default onto the tenant.

Lender Will Not Be Bound by Any Base Rent or Additional Rent that Tenant Might Have Paid for More than the Then-Current Month to Any Prior Landlord

This provision is fair and commonly granted by tenants, but should be tied into the lease requirements (e.g., "no rent has been paid more than one month in advance of the date required in the lease"). Such language will help avoid problems arising from situations where components of the rent may be paid on other than a monthly basis (e.g., semi-annual tax reimbursement).

Lender Will Not Be Bound by Any Amendment or Modification of the Lease Made without Lender's Consent

This provision is also commonly granted by tenants, but with three caveats. First, the provision should be limited to amendments that materially impact the landlord's rights or remedies under the lease. Second, the provision should not apply to any amendments that arise from the tenant's exercise of

an express right under the lease (e.g., an amendment memorializing tenant's exercise of an expansion or extension option). Third, to the extent that tenant agrees the lender's consent is required, that consent should not be "unreasonably withheld, delayed or conditioned."

Lender Will Not Be Bound by Any Assignment or Subletting by Tenant Made without Lender's Consent

Typically this provision should be deleted because it materially changes the terms of the lease. Where tenant must accept this provision, lender's consent should not be required for any assignment that the tenant has an express right to make under the lease (e.g., transfers to an affiliate or in connection with a merger). In addition, where the lender's consent is required, that consent should not be "unreasonably withheld, delayed or conditioned."

Lender Will Not Be Bound by Any Early Termination of the Lease Made without Lender's Consent

Typically this provision should be deleted as it materially changes the terms of the lease. It would be rare that an early termination would benefit a lender. Regardless, this provision should never apply to an early termination that arises under the casualty damage or condemnation provision in the lease. To the extent that the tenant agrees the lender's consent is required, that consent should not be "unreasonably withheld, delayed or conditioned."

Lender Will Not Have Any Obligation with Respect to Any Security Deposit Made by Tenant under Its Lease, Unless Physically Deposited with Lender

This provision should be deleted unless expressly required by the lease. If the lender is to get the benefit of the lease (e.g., future rental payments), the tenant should not forfeit its security deposit where the tenant has done nothing wrong.

Lender Will Not Be Required To Pay Any Improvement Allowances, Make Any Improvements for the Tenant's Benefit, or Be Bound by Any Warranties of Construction Made by the Landlord

This is often the thorniest issue in negotiations for an NDA or SNDA. Understandably, a lender does not want to end up in a situation where its borrower (the landlord) has defaulted, triggering a foreclosure, with the lender then required to come out of pocket to pay for unfinished landlord's work and/or a tenant improvement allowance. At the same time, the tenant relies on the initial landlord improvements and/or the tenant improvement allowance and the tenant's rent typically is higher to account for the return of those costs to landlord on an amortized basis over the initial term of the lease. Typically, a landlord will take its initial additional costs (e.g., landlord construction costs and/or tenant improvement allowance), amortize those costs of over the initial term of the lease (often at prime plus foour percent or more), divide by the square footage of the premises and add those costs to the rental rate. From the tenant's perspective, it is much like a loan, except the tax treatment is more advantageous to the tenant as the payments on that loan (i.e., a portion of the rent) can be often be expensed.

There are several ways to negotiate landlord improvement work and tenant improvement allowance issues in the NDA or SNDA, including the following:

- **Option 1:** Include an express provision that obligates any party that succeeds to the role of the landlord through a foreclosure be obligated to pay the tenant improvement allowance in accordance with the requirements of the lease. While an optimal solution from a tenant's perspective, most lenders (at least any institutional lender) will not accept this approach;

- **Option 2:** Include a provision that gives the tenant an express right to offset against rent any portion of the unpaid tenant improvement allowance and/or costs incurred by the tenant to complete work that the landlord was to perform. This approach is often structured as a recognition by the lender of an express offset right tenant has under the lease, but on occasion offset rights may need to be added when the SNDA is negotiated, particularly if the underlying lease contains a prohibition on the tenant claiming any offset rights;
- **Option 3:** Include a provision for the rent following any foreclosure to be adjusted to account for any portion of the tenant improvement allowance not paid to tenant and to account for costs incurred by the tenant to complete the landlord's work.

If the tenant cannot get lender cooperation on these issues or desires additional assurance with respect to landlord's required work or a tenant improvement allowance, consider one of the following approaches:

- **Approach A:** If the NDA is being negotiated concurrently with the lease or as a contingency to the effectiveness of the lease, the tenant could negotiate in the lease to require the landlord to pay the tenant improvement allowance to the tenant at the execution of the lease (or after any contingencies have been satisfied). Alternatively, the tenant improvement allowance could be placed in escrow for the tenant's benefit, with the only requirement to distributions from escrow to be reasonable construction draw provisions (e.g., sworn construction statements, lien releases). With respect to landlord required improvements, consider requiring funds to construct those improvements to be deposited into an escrow account for the joint benefit of landlord and tenant to be dedicated towards such mprovements, and include a mechanism for the tenant to access those funds should tenant be required to complete the landlord's work;
- **Approach B:** Require the landlord to provide credit enhancement to back up the tenant improvement and/or landlord construction obligations, either through an irrevocable stand by letter of credit or by a guaranty from a judgment worthy entity (e.g., landlord's parent entity or primary investor). While this may sound like an odd approach (e.g., landlord providing a guaranty from its parent entity), I have use this approach on several occasions to resolve this issue;
- **Approach C:** Include in the lease (or a lease amendment) a provision granting the tenant an express right to offset against rent if the tenant improvement allowance is not paid as required or if the tenant incurs costs to complete the landlord's initial construction obligations. Ideally, such an offset provision would include an interest factor equivalent to the interest factor the landlord used when incorporating its amortized costs into the rental rate. Any offset right should be structured as a right that is in addition to the right of tenant to declare the failure of landlord to pay a default, as the tenant may want invoke its offset rights without escalating matters by declaring a landlord default.

STEP SEVEN • Almost every lender will seek to get copies of notices from the tenant to the landlord as well as the right (but not obligation) to cure a landlord default under the lease. There are typically a number of issues raised by such a provision.

First, with respect to the notice component, the tenant will want to make sure that: (i) the lender is only entitled to a notice of default, not other general correspondence and notices under the lease; (ii) the tenant's obligation to provide the landlord with notices of default does not adversely impact the effectiveness of such notices against the landlord; and (iii) the tenant's obligation to provide notices is for

"prompt" notice rather than "simultaneous" notice (the best practice is to send the lender a copy of any landlord default notice contemporaneously with the notice from the tenant to the landlord).

Second, with respect to the cure periods, the lender should be limited in its cure period. Typically, a specific number of days following the expiration of landlord's cure period is appropriate (e.g., an additional 30 days). Many lenders will seek open-ended cure periods, which are typically crafted to allow the lender additional time to cure if in order to cure lender needs to take possession of the property. However, given that a foreclosure action will often take a considerable period of time, this is not an attractive approach for a tenant who would then be required to wait indefinitely for the foreclosure to be completed.

Third, the only remedy that the tenant should be required to forebear during any additional lender cure period is the right to terminate the lease as a result of the default. The tenant should not be required to wait to assert any claim for damages or any offset rights during the period following the expiration of the landlord's cure period and the expiration of the lender's additional cure period. Similarly, the lender's notice should have no impact on the tenant's right to seek declaratory or other equitable relief.

Fourth, many NDA's and SNDA's require any notice from the tenant to the lender to be given by registered mail, return receipt requested. Not only is this an outmoded form for notices, but it is also slow and these provisions are intended primarily to buy the lender additional time to cure. Tenant should make sure to add in the right to deliver copies of any notices to the lender by a "nationally recognized overnight courier service" or, when possible, by FAX or email/PDF.

STEP EIGHT • Many commercial mortgages and deeds of trust provide the lender with the right to apply casualty insurance and/or condemnation proceeds against the then outstanding principal under the loan. This is problematic for a tenant because the tenant is likely paying for the casualty insurance carried by the landlord and anticipating that the landlord (or tenant) will be able to use any insurance or condemnation proceeds to reconstruct the premises or other affected improvements. As a result, any provision in the SNDA or NDA that states that the mortgage or deed of trust provisions regarding the disposition of insurance or condemnation proceeds will prevail over the requirements for reconstruction in the lease should be deleted.

STEP NINE • Some lenders will include a provision in their NDA or SNDA that requires the tenant to covenant not to further subordinate its lease. In general, such provisions should be deleted as they will directly conflict with the tenant's typical affirmative obligation under the lease to subordinate the lease to any mortgage, deed of trust or ground lease entered into by the landlord and the tenant cannot control the actions of the landlord. To the extent that the lender wants assurance of no further mortgages/deeds of trust on the property, the lender should obtain that assurance from the landlord, not the tenant.

STEP TEN • Unless expressly required in the lease, remove any requirement for the tenant to provide the lender with periodic financial statements. Such provisions are an overreach by the lender and, at least with respect to privately held companies, many companies view such provisions as an improper intrusion into proprietary information in addition to the administrative burden such a provision creates for the tenant.

STEP ELEVEN • It is typically good practice to delete any attorneys' fees provisions in an NDA or SNDA. As between the tenant and the lender, the lender is the more likely party to seek enforcement of the NDA or SNDA and thus, more often

than not, any attorneys' fees provision in an NDA or SNDA will disproportionately benefit the lender. As between the tenant and landlord, attorneys' fees will be covered in the lease.

STEP TWELVE • Any NDA or SNDA should be a tri-party agreement, executed by the lender, landlord and tenant. Some lenders set up their forms only for the tenant's signature. Since the tenant is relying on the quid pro quo of recognition and non-disturbance protection from the lender in exchange for the tenant's subordination of its lease, the tenant has a vested interest in making sure that the lender also executes the NDA or SNDA. To the extent that the lender requests any covenant from tenant that may conflict with the tenant's obligations under the lease (e.g., tenant will send rent checks directly to lender following any notice from lender to tenant that the landlord has defaulted under its loan), it is important to the tenant that the landlord also signs the agreement so the tenant does not end up whip-sawed between its obligations under the lease and its obligations under the NDA or SNDA

Caveat: Remember is that the tenant and landlord will have an ongoing relationship under the lease and that the landlord is likely anxious to get the loan and/or to keep its lender happy. As a result, there is little to gain from needlessly upsetting the landlord or lender. A bit more cooperation than required often benefits a good landlord/tenant relationship. The easiest component of cooperation is to be prompt and responsive. Landlords often are more concerned with the return of a proposed NDA or SNDA in a timely manner, than with tenant proposed modifications to that document. Also, it is often prudent to have some flexibility on minor issues (e.g., not paying rent more than one month in advance, providing lender with copies of any notices of default) that do not materially and adversely harm the tenant.