

Subordination Without Nondisturbance: A One-Sided Marriage

Part Two of a Two-Part Article

By Jeffrey H. Newman

Just as tenants with the requisite negotiating leverage protect themselves from the potentially harsh effects of a naked subordination agreement by assuring themselves that mortgagees will (among other things) recognize and assume the landlord's obligations under the lease, mortgagees seek to avoid agreeing to assume certain obligations, particularly old repair-maintenance obligations that the landlord has neglected and that would usually become the mortgagee's obligation in the event of foreclosure.

MORTGAGEE OBLIGATIONS AND EXCEPTIONS

The nondisturbance elements discussed in Part One of this article (*Commercial Leasing Law & Strategy*, January, 2011) require the mortgagee to "recognize" the tenant's leasehold and its rights thereunder. It is virtually axiomatic that when a mortgagee takes possession from a defaulting borrower-landlord, the mortgagee encounters the harsh reality of a neglected piece of real estate.

Quite possibly, the tenant will have also declared the landlord in default because the landlord has failed to honor its repair-maintenance obligations under the lease. In fact, the tenant may have exercised a self-help remedy and expended

its own funds for maintenance or repairs that cured the landlord's defaults. Thus, in a common scenario, two innocent parties, the tenant and the mortgagee (who has now become successor landlord), must determine who bears responsibility for the sins (either of commission or omission) of the prior landlord.

LANDLORD'S DEFAULTED OBLIGATIONS

Not surprisingly, mortgagees seek exculpation from all the past obligations that devolve on them following foreclosure because they automatically assume the prior landlord's responsibilities (fulfilled and unfulfilled) under the lease.

Over the years, mortgagees have developed a litany of exemptions to pursue during negotiations. Although many are reasonable from a tenant's perspective, others appear to favor the mortgagee unfairly. In general, mortgagee/successor landlords seek exculpation from any acts or omissions of the prior landlord and refuse to be subject to any offsets or defenses that the tenant was (and is) entitled to assert against the prior landlord. Although this clean-chalkboard approach is asserted as merely removing the mortgagee from participation in disputed landlord-tenant obligations, in effect it simply favors the innocent mortgagee over the innocent tenant in the determination of who must cure or be responsible for curing the prior landlord's defaults.

Both mortgagee and tenant negotiators can wax eloquent about their respective entitlement to exoneration. Because valid arguments exist on behalf of both parties, compromise must be sought.

Tenant negotiators attempt to modify a mortgagee's request for complete exemption from the landlord's defaulted obligations by keying exemptions to the mortgagee's acts before the mortgagee took over the property, but after the tenant has

notified the lender of the landlord-mortgagor's default. For example, most subordination agreements require the tenant to notify the mortgagee of all landlord defaults, to provide the mortgagee with ample opportunity to cure, and to further notify the mortgagee before it uses any self-help measures available under its lease to cure the default. If the tenant has fulfilled its notification obligations, it can make the following argument: The mortgagee should not be entitled to ignore a mortgagor default about which it has received multiple notifications from the tenant and that it has had a reasonable opportunity to cure.

Because the mortgagee has not availed itself of the opportunity to cure, the tenant can argue its greater innocence and demand that the mortgagee assume post-foreclosure responsibility for the prior landlord's defaults. On the other hand, a mortgagee may assert that certain cures cannot easily be effected and may even jeopardize the validity or value of the mortgagee's lien.

Except in these special situations in which a cure was impossible or impracticable or threatened lien validity, if the tenant in fact met all of the mortgagee's notice preconditions, it has a strong argument that the mortgagee should become liable for such defaults when it takes over the property. The parties sometimes arrive at a cost-sharing formula to compromise this issue. A quick-fix solution might call for a 50-50 sharing of the costs of many obligations with mortgagee exceptions related to special circumstances.

Yet, given their bargaining leverage, most mortgagees simply will not compromise in the subordination agreement on the issue of uncured landlord obligations. However, the equities certainly justify tenants' raising the issues. When mortgagees retain full exoneration, they,

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in effect, pass on to the tenant the costs of properly maintaining the mortgagee's collateral.

Tenant negotiators sometimes argue that some or all of the burden of post-foreclosure cure of pre-foreclosure landlord defaults should fall on the lender because the lender analyzed the entire loan transaction on a risk of default basis while the tenant analyzed its lease aspect of the transaction on an operating profit basis. They argue that lenders generally have deeper pockets than tenants and are better equipped to expend due diligence dollars to analyze the borrower's and projects' creditworthiness. Ultimately, allocation of the costs of post-foreclosure cures is determined by complex factors that may have little to do with logical argument.

THE PROBLEM OF PREPAID RENT

After the foreclosure, the lender may discover that tenants have made extensive prepayment of rents, the proceeds of which — along with other required payments — never found their way to the mortgagee. Therefore, another classic exculpation sought by mortgagees is protection against such prepayments of basic rent and additional rent. The lender wants a situation in which the tenant is deemed to have made such prepayments at its sole risk, and if the prepayment was misapplied, the tenant after foreclosure must pay to the mortgagee the same obligation when it actually becomes due. While such a clause relating to basic rent has merit, it is inappropriate and unfair to make a tenant liable to a mortgagee for tax or other additional rent payments that the tenant has been required to make under the terms of the lease, on a multi-month basis. Accordingly, the mortgagee is entitled to prepayment protection only in cases of voluntary, as opposed to required, prepayments of additional rent.

OTHER EXEMPTIONS OF MORTGAGEE OBLIGATIONS

Mortgagees often insert provisions into subordination agreements that declare any amendment to the tenant's lease to be void and of no effect unless the mortgagee consented to the amendment. Such a clause is probably unnecessary (it should be subordinate to the previously consummated subordination agreement); it also could be unfair because it prevents the landlord and tenant from readily making appropriate lease modifications. Mortgagees want these provisions in order to

prevent collusive arrangements between the landlord and tenant that impair the mortgagee's collateral. The parties must balance this protection against the need of landlord and tenant to be able to adjust the lease efficiently and effectively. One compromise that seems fair provides that basic material lease provisions (*e.g.*, rent, term, options) cannot be modified without the mortgagee's consent; furthermore, the mortgagee is not bound by any changes in other terms regardless of whether it had knowledge of them, actual or constructive, unless it consented to them.

Mortgagees often seek other, perhaps less appropriate, exemptions. Mortgagees often seek to exculpate themselves from any of the landlord's construction obligations. In addition, mortgagees may seek to prevent the lease from being canceled or modified and sometimes even try to prevent the lease from being assigned.

After a foreclosure, a mortgagee may quickly become unwilling to obligate itself for certain construction obligations in its tenant leases, arguing that it should not be required to undertake the expenditures necessary to complete a prior landlord's defaulted construction obligations. The tenant's argument is that since the construction obligations are directly or indirectly funded by the mortgagee, there is little practical difference between the mortgagee's payment of construction funds to the landlord's general contractor and its payment to a general contractor that it hires directly. The mortgagee's counter argument is that it never intended to become an owner of real estate and to be forced to complete construction of a project that it must eventually sell, perhaps in a "forced" sale. That obligation would be both unfair to the mortgagee and an unrealistic expectation of the tenant. Equitable tenant arguments include the assertion that the tenant has foregone other competing locations and has expended time and money planning to use the lost location.

On balance, mortgagees prevail on this issue unless the tenant is a sole user or represents a large percentage of the total project. Such large tenants may be able to obtain a firm commitment to project completion. However, tenants should treat the lender's demands for control of the right of assignment as overreaching, and they should reject the demand.

In effect, the mortgagee is asking that it be able to "unnegotiate" these rights (as well as rights respecting cancellation), which may have been created after either months of negotiation between the tenant and landlord, or after years of operation with such rights in place under the lease. Mortgagees must assume that the borrower/landlords are attempting to obtain the best tenants on the most landlord-advantageous terms possible. If mortgagees wish to negotiate or renegotiate leases, perhaps they should take equity positions and assume responsibility for leasing.

MORTGAGEE'S RIGHTS TO CURE

Whether or not mortgagees accept the assumption of potential liability alluded to earlier, they seek the right to cure any default of their borrower/landlord. A mortgagee's right to cure should be tempered in two ways. First, it should be subject to a tenant's overriding immediate right to cure in the event of an emergency (assuming the tenant is in possession and operating).

Next, the mortgagee should have a finite, reasonable time (not unlimited) within which to effect a cure, after which the tenant may do so. This prevents the mortgagee from deferring exercise of its right throughout a lengthy foreclosure process that may inhibit a mortgagee from effecting certain cures. Foreclosure in some jurisdictions can take two or three years or more.

CONCLUSION

A mortgagee wants the right, after foreclosure, to maintain forever the marriage created between its defaulted borrower and its defaulted borrower's tenant. Moreover, mortgagees want the marriage continued on their own terms and are generally not willing to make a reciprocal vow. However, most tenants are entitled at least to some loving, honoring, and cherishing. Once the parties agree conceptually on the need for reciprocity in the relationship, tenants must read the marriage contract carefully, because some rain falls on every parade.