

## Subordination Without Nondisturbance: A One-Sided Marriage

### *Part One of a Two-Part Article*

By Jeffrey H. Newman

If love and marriage go together like a horse and carriage, surely a demand for subordination should be followed by a request for nondisturbance. For purposes of this article, it is assumed that the request (demand) for subordination is being made by a landlord (currently in lease negotiations with a prospective tenant) who intends to effect a financing either in the near future for initial permanent funding, or in the distant future for perhaps expansion or eventual refinancing. In effect, subordination (and attornment) by a tenant is the tenant's vow to remain a tenant through good times or bad (including foreclosure and its aftermath), for better or for worse; but, if the landlord does not give the tenant nondisturbance protection, the landlord is not reciprocating the vow. Naked subordination (subordination without nondisturbance) allows any mortgagee who may succeed to the landlord's position by foreclosure to accept or reject the tenant (*i.e.*, honor or terminate the tenant's lease) by virtue of the tenant's subordinate position.

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A tenant will be subordinate to a lender who "takes over the property" by foreclosure either because the lender's mortgage was recorded prior to the execution of the tenant's lease (whether or not the lease is recorded), or because the tenant, whose lease was prior in time to the recordation of the lender's mortgage, executed a subordination agreement. Recent events have shown that the previously unlikely scenario of a landlord default followed by a lender takeover is not only possible but is no longer a rarity. As a result, many tenants are now vulnerable to successors in interest who may either terminate their leaseholds or continue them after weakening many leasehold rights. Accordingly, tenants must start to focus on subordination provisions in order to ameliorate the harsh potential results of naked subordination.

### **THE SUBORDINATION CLAUSE**

A subordination clause (as generally found in a landlord's form lease or in a separate form subordination agreement prepared by the landlord's mortgagee) makes all tenants' rights junior, subject, and subordinate in all respects. Classically, the interest that the clause makes superior to that of a tenant is that of a subsequent lender/investor whose interest is evidenced by a mortgage or deed, depending on the jurisdiction. In this article, all interests superior or desiring to become superior to the tenant's lease are referred to as a mortgage. The subordination clause elevates all mortgages that, because they were executed after the tenant's lease, would otherwise be junior to the tenant's lease interests. The mortgages become

superior pursuant to the subordination agreement, even if the lease or a memorandum thereof is recorded (just as a deed is recorded) prior to the recordation of the mortgage. The mortgages have been made contractually senior.

Landlords seek to subordinate tenants' leasehold interests because they know that lenders will require such subordination. Before they agree to a financing, mortgagees require all of the borrower/landlord's tenants to execute subordination agreements. If some of the tenants are not obligated to do so and, in fact, refuse, the landlord finds it significantly more difficult (certainly costlier and, perhaps, impossible) to effect a financing or refinancing. By requiring tenant subordination, lenders are, in effect, granting themselves the right to terminate a tenant's lease following foreclosure. Thus, they assure themselves a freer hand to remolecularize a distressed property. (The mortgagee, at its option, can also elect to honor the tenant's lease, thereby requiring the tenant to remain in place, to honor its obligation to attorn to the mortgagee, as if nothing had occurred.) Subordination agreements specifically provide for a tenant to attorn to the lender such that the lender can be assured that, in the event of foreclosure, if the lender so elects, the tenant will remain a tenant and acknowledge the lender as its new landlord. However, stronger tenants know that the mortgagee requirement of absolute subordination, without any nondisturbance protection, is not ironclad.

### **NONDISTURBANCE PROTECTION**

Because naked subordination leaves the tenant at the whim of the superior

interest, tenant negotiators in this period of landlord default and lender takeover must fight hard to obtain some nondisturbance protection. Lack of nondisturbance protection exposes the tenant to the devastating result of lease termination. Although this eventuality would hurt any tenant, retail commercial tenants are particularly devastated by unexpected terminations because their locational-operational goodwill is wiped out unless they find a sufficiently proximate new location to which to transfer their premises. (See J.H. Newman, "The Option Period — Is It a One Way Street Called 'Tenant Avenue?'" *Real Estate Review* 21 (Fall 1991), p.77, for a discussion of operational goodwill.)

Tenants that seek nondisturbance protection generally are successful because landlords recognize that tenants need it, and mortgagees will provide at least some protection. An existing mortgagee interest is already senior to the rights of a subsequent tenant. That mortgagee does not need the subordination clause in the leases of subsequent tenants and has absolutely no need or reason to offer any protection to those tenants. Strong tenants should require landlords to undertake good-faith efforts to obtain nondisturbance protection from existing mortgagees. In fact, the strongest of tenants usually demand nondisturbance and recognition protection from current mortgagees as a condition to entering into leases with landlords whose properties are thus encumbered. Future mortgagees, however, need and demand subordination from earlier tenants, and most tenants generally can obtain at least limited nondisturbance from these lenders.

Nondisturbance protection comes in various shapes and sizes. Often, after long negotiations, the nondisturbance language that a lender inserts into a subordination agreement with the tenant provides far less protection than the tenant needs. Frequently, the best language that the tenant can extract from the lender protects only the tenant's possessory rights. But the tenant requires much more than a mortgagee's agreement not to disturb the peaceful and quiet possession

of the premises. A lease confers not only possession, but an additional bundle of rights upon the tenant, and it places a bundle of obligations upon the landlord. Consequently, a nondisturbance provision in a lease that fully protects the tenant (or the nondisturbance language that must be inserted into a subordination agreement) must secure both the tenant's bundle of rights and the tenant's ability to enforce the bundle of obligations that the landlord has undertaken.

#### **THE TIMING OF RIGHTS AND OBLIGATIONS**

An important subject of nondisturbance rights negotiations concerns when they become operative or effective. In the usual case, the superior mortgage document (or documents related to it) confers rights upon the mortgagee that are inconsistent with or modify the tenant's rights under the lease. Thus, the tenant loses certain rights as soon as the subordination agreement is executed, regardless of whether a foreclosure or similar event ultimately occurs.

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However, although the tenant subordinates its rights in the present, the nondisturbance provisions and protections often become effective only upon lender takeover, a circumstance that may never occur. The divergence in timing creates the potential for devastating consequences.

For example, a damage and destruction clause in a lease may require the landlord in all events to rebuild the leased premises. The damage and destruction clause in a mortgage generally permits the mortgagee, at its election, to apply the insurance proceeds to reduce the principal balance of the mortgage; if the mortgagee chooses to do so, the landlord

will probably be unable to rebuild the leased premises. Because the lease becomes subordinate to the mortgage upon execution of the subordination agreement, the mortgage's damage and destruction clause immediately governs, unless the nondisturbance language specifically protects the tenant. The mortgagee can cause a termination of the lease in the event of damage to or destruction of the leased premises because it can withhold the funds that the landlord needs to rebuild or repair the property — or simply because language in the mortgage allows for termination in the event of material damage or destruction or a material condemnation.

The tenant does not need a complex protective clause. Fairly concise, quick-fix language requires the mortgagee to "immediately honor all of the tenant's rights under the lease as well as to honor all the landlord's obligations under the lease." The parties could then specify in detail those tenant rights or landlord obligations that are inconsistent with the mortgage. The agreement should indicate that for those rights and obligations, the provisions of the lease should govern and should prevail over those of the mortgage. Because inconsistencies virtually always exist between the lease's damage and destruction clauses (and condemnation clauses) and those of the mortgage, the mortgagee's representation that it will honor all of the obligations of the landlord probably should be supplemented by the phrase, "including, but not limited to, the use of insurance and condemnation proceeds."

Thus, the tenant has obtained immediate protection from inconsistencies between the lease and the mortgage that could impair or wipe out important tenant benefits, as well as the protections that it will need if and when the mortgagee forecloses on the landlord's interest.