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FINANCING

Current Market Refocuses Attention on 'SNDA' Agreements



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In our last column (May 19, 2010), we analyzed certain issues related to tenant estoppel certificates in the context of a mortgage financing; in this column we will look at another loan document that requires execution by tenants of the subject property, the Subordination, Non-Disturbance and Attornment Agreement, commonly referred to as an SNDA. Two market factors are helping SNDAs emerge from relative obscurity and confusion to a new level of importance in today's real estate finance arena.

First, as foreclosures and deed in lieu transactions become increasingly common, SNDAs serve to establish ground rules for the ongoing relationship between newly minted landlords (former lenders or lenders' designees) and their tenants. Second, new loan offerings are currently dominated by low-leverage financings secured by properties leased entirely or primarily to large, credit-worthy tenants that, in essence, offer credit enhancement to the loan transaction. In each case, SNDAs, which are normally ancillary to the principal credit agreements and guaranties, ought to be scrutinized to better evaluate lender obligations and liabilities following a foreclosure, whether imminent or not.

Generally, the name of the document is a good description of its purpose, the tenant agrees that its lease is subordinate to the lien of the mortgage (even if recorded prior to the mortgage), the lender agrees that if it forecloses on the collateral property or otherwise takes title thereto, it will not disturb the tenancy of the tenant (for example, it will not foreclose out the lease) and, in the event the lender takes title to the property, the tenant agrees to attorn to the lender (recognize the lender as its new landlord).

Additionally, the provisions of an SNDA often require lender consent to any amendment or modification of the subject lease. In connection with a mortgage financing, lenders typically require SNDAs from the major tenants of a collateral property as a closing condition. All too often, however, the parties to an SNDA fail to understand the significance, or lack thereof, of such an agreement. While it is not unusual for the

lease of a material portion of a collateral property to contain its own self-subordinating language, such provisions vary widely and frequently require the execution of an SNDA by the lender.

Furthermore, while a lease may contain subordination language, it may not include non-disturbance or attornment provisions that pertain to a foreclosure situation, and, absent an executed SNDA, such omission may result in unintended consequences.

The relative priority of the lien of a mortgage or deed of trust to that of the leases granting possessory interests in the collateral property is of particular importance to both lender and tenant because it will, under certain circumstances, dictate the relevant consequences of a foreclosure.

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In all jurisdictions, when a lease is deemed superior or prior to the mortgage, the terms of the lease will automatically survive foreclosure. As a general matter, in the absence of an SNDA, the rule of "first in time, first in right" establishes priority in all jurisdictions.¹ What is required to be considered superior, however, varies from state to state. In certain jurisdictions, executing and subsequently recording a notice or memorandum of a lease prior to the perfection of a mortgage is required in order for such lease to be deemed superior to the lien of the mortgage.² Race-notice states, New York for example, operate under this rule. In other jurisdictions, occupancy itself establishes priority, so if a tenant possesses the demised property prior to the recording of the mortgage, the mortgage is presumed to be subordinate to the lease.

In the context of a foreclosure on a collateral property with subordinate leases and no SNDAs, states have different rules with respect to the foreclosure's effect on the tenant and lender's respective rights to terminate such leases. The incentives of both the tenant and lender to enter

into an SNDA, therefore, may theoretically be influenced by the rights and protections individual state law provides in the event of foreclosure. In some states, such as New York, provided no SNDA has been executed, the lender enjoys the ability to determine which subordinate leases to enforce and which to terminate upon foreclosure.³ For this reason, New York's approach may be categorized as a lender-friendly "pick and choose" system.

There are, however, certain statutory limitations that affect the lender's freedom to pick and choose between favorable and unfavorable leases.⁴ For example, if a lender seeks to extinguish a subordinate lease upon foreclosure, the lender must name the tenant as a defendant in the foreclosure action. Failure to properly name and serve a tenant will prevent the foreclosing lender from terminating the subject lease, even if subordinate to the relevant mortgage.⁵ In such a circumstance, both the lender and tenant are bound by the terms of the lease, with neither party having the right to unilaterally terminate.

Section 291-f of the Real Property Law of New York provides additional protections to lenders and renders attornment provisions arguably unnecessary from a lender's perspective. That is not to say, however, that as a practical matter, SNDAs are less common in New York than in other jurisdictions. Under §291-f, a lender and borrower may enter into a mortgage agreement that restricts the ability of a landlord to cancel or modify existing tenancies or leases of the mortgaged property, or to accept prepayments of future rents due, without the lender's consent.⁶

The statute further provides that such a clause will be binding upon the tenant, so long as the mortgage is recorded and written notice of the restrictive covenant is provided to the tenant. Upon the tenant's receipt of notice, or deemed notice, of §291-f language in a mortgage, any termination, prepayment or other modification of the lease entered into without the specific consent of the lender, would be unenforceable against such lender or its designee, as landlord, upon foreclosure. In states that do not have statutes similar to §291-f, lenders rely on provisions of the SNDA to prevent amendments or modifications of a lease without their consent.

Dime Savings Bank of New York, FSB v. Montague Street Realty Associates serves as an example of this statute and the New York rule at work.⁷ In *Dime Savings Bank* a lender sought to

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foreclose on a mortgage that expressly prohibited the borrower-landlord from accepting the prepayment of any rents due under any lease of the property without the lender's consent. Despite this provision, the tenant and borrower-landlord entered into a modification, without the lender's consent, extending the lease for an additional five years, and requiring the tenant to prepay \$160,000 in rent installments.

Several months later, the borrower-landlord defaulted on its mortgage loan, and the lender foreclosed. The tenant refused to pay its new landlord rent for the ensuing months on the grounds that it had already prepaid the rent for such period to its previous landlord under the extension agreement.

The court first dealt with the issue of whether the extension agreement constituted a new lease subordinate to the mortgage or whether it represented a mere continuation of the original lease, in which case it would have been senior to the mortgage. The court determined that the lease extension was a new agreement, focusing particularly on the new rent prepayment provision.

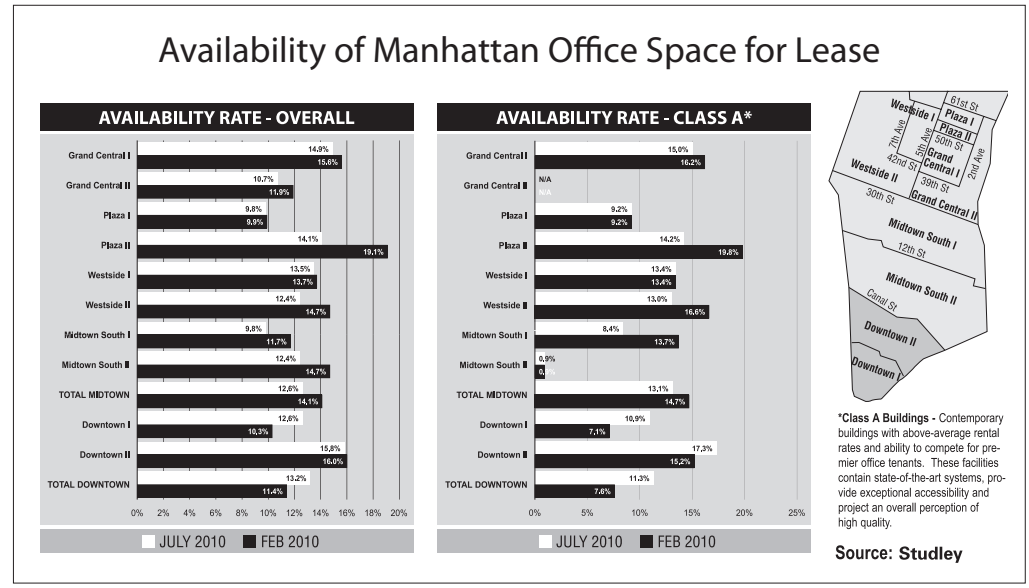
With the new lease deemed subordinate to the mortgage, the court recognized the lender's right to maintain the lease after foreclosure, consistent with New York's pick and choose rule. Thus, the Supreme Court, Appellate Division, and Court of Appeals, all agreed that the tenant should be bound to the terms of the lease and compelled to attorn to the lender and pay the rents due, even without an SNDA in place.

Further, the Court of Appeals relied on the restrictive covenant against prepayment of rent in the mortgage to deny the tenant's argument that it already paid rent for the period in question, even though written notice of the covenant was not provided to the tenant. In doing so, the court interpreted §291-f as only requiring written notice of a mortgage's restrictive covenants to tenants with leases superior to the subject mortgage.

Thus, in New York, lenders may hold tenants to the terms of a subordinate lease after foreclosure on the property, even without the tenant promising separately to attorn. The New York statute, therefore, arguably eradicates one of the primary concerns of lenders seeking attornment provisions—that the property will fail to provide the anticipated stream of revenue post-foreclosure because tenants have the ability to simply walk away from unfavorable leases. The desire to avoid uncertainty however, whether as to the relative priority of a mortgage and lease or a court's interpretation of the specific facts and circumstances explains the continued prevalence of SNDAs in New York and similarly situated jurisdictions. Prudent mortgage lenders in New York should insist upon SNDAs from any significant tenant and additionally issue §291-f notices to all tenants upon the closing of such financing.

The law in California differs significantly from that of New York. California may be categorized as an "automatic extinguishment" or "automatic termination" state, because, in the absence of an SNDA providing otherwise, a lender's foreclosure on the borrower's property will automatically extinguish an existing lease that is subordinate to the relevant mortgage or deed of trust.

In *Dover Mobile Estates v. Fiber Form Prods. Inc.*⁸ a lease that was subordinate to the relevant deed of trust and that did not contain a non-disturbance



provision or, apparently, attornment language (and no separate SNDA was entered into), was found to be automatically extinguished after a trustee's foreclosure sale of the collateral property. The court held that as a result of the foreclosure sale, the lease had been automatically extinguished and that the tenant remained in possession thereafter pursuant to a month-to-month tenancy, terminable on thirty (30) days notice. After negotiations to reduce the rent fell through, the tenant gave notice and was entitled to walk away.

In *Dover Mobile Estates*, it was the tenant, rather than the lender, that desired the termination (or perhaps the non-renewal) of an above-market lease and thus the foreclosing lender ended up receiving a significantly lower monthly cash flow than it had anticipated.

The Court of Appeals' (Sixth District of California) decision would also apply to a situation in which a foreclosing lender desired to terminate a below-market lease during the foreclosure process, thereby potentially cutting both ways depending on which party desired lease termination. The court pointed out that a tenant wishing to maintain its lease would be protected by a properly drafted subordination, non-disturbance and attornment agreement.

Despite the general custom, there is no requirement that SNDAs be recorded in order to be enforceable. There are some advantages, or at least perceived advantages, to recording SNDAs for both lenders and tenants however, so it has become the general practice. For example, when a lease has priority over a mortgage, either because it has been recorded or because the tenant has possession at the time the mortgage is perfected, depending on the jurisdiction, the lender has an increased incentive to record an SNDA.⁹

In the event a mortgage is superior to the relevant lease, the property's location in an "automatic termination" versus a "pick-and-choose" state may be a factor influencing the decision whether to record the SNDA.¹⁰ In automatic termination states, arguably neither party needs to worry about recording an SNDA, because they can both be confident the courts in these jurisdictions will enforce the provisions without recording.¹¹

In New York, lenders similarly might not care whether an SNDA is recorded, because the state's version of the pick-and-choose rule already provides lenders with sufficient rights and protections.¹² A recorded document however, avoids certain evidentiary issues and possible disagreements as to the ultimate terms and conditions of an agreement.

Additionally, if a lease, or notice thereof, has been recorded against a collateral property, recording the relevant SNDA avoids any confusion as to the intent of parties with respect to priority. In other words, one common concern is that courts will be more likely to recognize and enforce SNDAs if they are recorded. The legitimacy of this concern, however, is up to debate.¹³

The current climate of mortgage lending has propelled the SNDA from obscurity to greater importance and despite the claim of some commentators that the value of such an agreement is overstated, at least in New York and similarly situated jurisdictions, good lending practice and the desire for certainty dictates that SNDAs are an important part of mortgage lending documentation and are not to be overlooked.

1. See Thomas C. Homburger & Lawrence A. Eiben, "Who's on First—Protecting the Commercial Mortgage Lender," 36 REAL PROP. PROB. & TR. J. 412, 416 (2001).

2. See id.

3. See Homburger at 417.

4. See id.

5. See Joshua Stein, "Needless Disturbances? Do Nondisturbance Agreements Justify All the Time and Trouble?," 37 REAL PROP. PROB. & TR. J. 704, 728-29 (2003).

6. N.Y. REAL PROP LAW 291-f (McKinney 1989).

7. *Dime Sav. Bank v. Montague St. Realty*, 90 N.Y.2d 539, 686 N.E.2d 1340, 664 N.Y.S.2d 246 (Ct. App. 1997).

8. *Dover Mobile Estates v. Fiber Form Prods. Inc.*, 220 Cal. App.3d 1494, 270 Cal.Rptr. 1983 (Ct. App. 1990).

9. See Homburger at 425.

10. See id.

11. See id.

12. See id.

13. See id. at 426; Stein at 760.