NEEDLESS DISTURBANCES? DO NONDISTURBANCE AGREEMENTS JUSTIFY ALL THE TIME AND TROUBLE?

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Editors' Synopsis: This Article discusses the agendas that drive any subordination, nondisturbance, and attornment agreement (an "SNDA") and the issues that arise in negotiating and preparing an SNDA. This Article critiques some assumptions that underlie an SNDA and the negotiating positions that parties to these agreements often take. The Article suggests some measures to simplify the entire process.

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INTRODUCTION

Commercial leases create real estate value.[1] Commercial mortgage[2] lenders lend against real estate value. In the course of these transactions, either a tenant or a lender will often ask the landlord to obtain a subordination, nondisturbance, and attornment agreement (an "SNDA") from the landlord's other counterparty—the lender or the tenant, as the case may be. Every time that happens, the worlds of leasing and lending overlap, but often in a rather awkward and uncomfortable way.

An SNDA embodies some agreements between a tenant and a lender, relating mostly to what happens to the tenant if the lender forecloses under its mortgage. Absent an SNDA, a lease represents a two-way negotiation and relationship between a landlord and a tenant. An SNDA brings a lender into that relationship. A lender's agenda goes beyond the landlord's.[3]

This Article explores the practical and legal backdrop of SNDAs, why lenders and tenants think they need SNDAs, and some issues and problems that arise in preparing and negotiating an SNDA. This discussion complements the previously published New York State Bar Association Report on Nondisturbance Agreements, with Model Form of Nondisturbance Agreement ("Report and Model SNDA").[4]

This Article includes a few questions, some of a rhetorical nature intended to provide discussion and thought. Those questions: (a) challenge some assumptions that underlie an SNDA and the related legal issues; (b) critique some positions taken by all parties in SNDA negotiations;

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[1] The short-term and medium-term value of commercial real estate depends primarily and most directly on the existence of stable tenants that have agreed to pay a reliable stream of rent for a known period. Without reliable rental income, commercial real estate in the short or medium term easily can look more like a liability than an asset. Of course, vacant space has a value, but it is contingent and hypothetical until a real tenant signs a real lease to turn the space into a real income stream.

[2] Except where otherwise stated, any reference to a "mortgage" also refers to a "deed of trust."

[3] As in so many other areas of commercial real estate, though, if the landlord plans ahead to the inevitable lender, the landlord's agenda will (in part) simply track the anticipated lender's agenda, and life will be easier for everyone.

[4] *See Report of Subcommittee on Nondisturbance Agreements*, 22 N.Y. STATE BAR ASS'N REAL PROP. L. SEC. NEWSLETTER, No. 2 (Spring 1994). The author chaired the subcommittee that prepared the Report and Model SNDA. The Report and Model SNDA analyzed the terms of an SNDA, paragraph by paragraph, without questioning the fundamental logic of the exercise. This Article focuses more (and more critically) on the underlying structure, dynamics, rationale, logic, and purpose of an SNDA. The coverage overlaps to some degree.

(c) question whether SNDAs really justify the time, energy, effort, and thought that they can consume; and (d) suggest other ways to mitigate or resolve the risks that an SNDA seeks to resolve.

This Article concludes by suggesting that some of the issues that motivate SNDAs are not really issues at all, and that borrowers, tenants, and lenders might be better served by taking a different approach to the lender-tenant relationship, one that eliminates the need for an SNDA and simplifies the lease negotiation and loan closing process.

What is most remarkable about the law on SNDAs is how relatively little of it exists, particularly outside California and New York. A few cases have addressed the issues of subordination and interaction of estates that drive subordination agreements. Others have addressed the lease-related risks that lenders try to mitigate through SNDAs. Almost no cases directly consider the interpretation or enforcement of SNDAs. For an area that so often consumes so much time and effort for lenders, landlords, and tenants and all of their attorneys, one might expect to see more litigated cases, and more recent ones.

Why doesn't more case law exist on the issues that seem so pressing and major to lenders and tenants when they negotiate an SNDA? Perhaps real estate attorneys have identified and resolved all issues in this area so well that the courts simply don't need to intervene. More likely, the problems and risks an SNDA covers, although theoretically conceivable, do not arise all that often in the real world. And the parties may simply figure out ways to work out acceptable solutions to whatever problems actually do arise.

Regardless of why this area of real estate law seems so rarely litigated, it can be a significant battleground in any major commercial lease negotiation or the closing of any commercial mortgage loan. A recent New York case recognized the weight that parties to a real estate transaction attach to SNDAs.[5] In that case, a loan purchaser agreed to purchase a commercial mortgage loan, but refused to close when the seller could not deliver an SNDA with a major tenant.[6] The seller sued to keep the deposit, claiming that the lack of an SNDA did not give the purchaser a valid basis to walk away from the deal.[7] The court awarded the purchaser a full refund of the

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[5] *See* Teachers Ins. & Annuity Assoc. of Am. v. Ocwen Fin. Corp., No. 98 Civ. 7137, 2002 WL 237836 (S.D.N.Y. Feb. 19, 2002).

[6] *See id.* at *1, 7, 10.

[7] *See id.* at *7, 10.

deposit because failure to deliver the SNDA constituted a material breach.[8] Although this case (as does every case) depended very much on its particular facts, it does demonstrate the importance a lender can attach to an SNDA and some judicial recognition of that importance.

Perched as it is at the juncture between commercial leasing and commercial mortgage lending (probably two of the main practice areas in a typical commercial real estate lawyer's workload), the topic of SNDAs also introduces, in a single compact package, many fundamental issues that arise in those two areas of practice. In particular, SNDAs require an understanding of how multiple interests in the same real property interact, thus introducing themes that run throughout real estate law and practice. Attorneys who negotiate commercial leases or commercial mortgage loan documents, whether for landlords, tenants, lenders, or borrowers, care about the issues and dynamics of an SNDA because these are the fundamental issues and dynamics of any sophisticated commercial real property transaction.

I. OVERVIEW OF AN SNDA

An SNDA memorializes an agreement between a commercial mortgage lender and a commercial tenant about their relationship, and, primarily, about what happens to the tenant's lease if the mortgage lender ever forecloses. The landlord often joins in the agreement, or at least consents to it.

To accomplish these goals, an SNDA will usually include the following elements:

> *1. Subordination*. The tenant agrees that its lease is subordinate to the mortgage. Absent agreement to the contrary, this means:
>
> *a. Priorities*. The legal priority of the lease (and the tenant's interest in the property) is junior to the legal priority of the lien of the mortgage.
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> *b. Inconsistencies*. The terms of the mortgage will prevail over the terms of the lease whenever they conflict.[9]
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> *2. Foreclosure*. If the lender forecloses, the foreclosure can terminate the lease.

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[8] *See id.*

[9] *See* BLACK'S LAW DICTIONARY 68 (7th ed. 1999) (defining a subordination agreement as "an agreement by which one who holds an otherwise senior interest agrees to subordinate that interest to a normally lesser interest").

3. Nondisturbance. The lender agrees that if it completes a foreclosure or similar action against the borrower (the landlord), the lender will not disturb the tenant's right of possession (hence, "nondisturbance"). A nondisturbance agreement assures the tenant that when a new owner[10] steps in and takes title through any foreclosure of the mortgage or similar action (a "Successor Landlord"), the Successor Landlord will not deprive the tenant of the tenant's right of possession (and other rights) under the lease, provided that the tenant is not in default under the lease.[11]

4. Attornment. In an attornment agreement, both lender and tenant assume certain responsibilities. The tenant agrees to attorn to, or recognize, the Successor Landlord as the tenant's new landlord if the lender ever completes a foreclosure.[12] The lender agrees that the Successor Landlord will perform the landlord's contractual obligations under the lease. In any event, attornment contemplates that tenant and Successor Landlord will continue the lease after foreclosure with a direct landlord-tenant relationship, on the same terms as the previous landlord-tenant relationship, subject to any changes in the lease that the SNDA requires.

Until foreclosure, the SNDA also creates a direct contractual relationship privity of contract between lender and tenant, so that both parties know they will have direct rights against each other

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[10] The new owner could be the lender as the highest bidder at the foreclosure sale, or it could be a third-party bidder or a transferee that the lender procures. Many SNDAs protect only the lender (or its affiliate or designee) if it acquires the property, but not a third party purchaser.

[11] Although lenders often prefer to condition nondisturbance on the absence of any default under the lease, the Report and Model SNDA requires a full unconditional nondisturbance unless and until the lease actually has been terminated because of an event of default. Any strong and well-represented tenant will insist on this level of nondisturbance protection, and lenders will typically agree to it. As a middle ground, the parties will condition nondisturbance protection upon the absence of any default that has continued beyond applicable cure periods under the lease. To the extent that a tenant's nondisturbance protections go away upon something less than a full termination of the lease, they may let the lender terminate a troublesome tenant through foreclosure rather than through landlord-tenant proceedings. The former may perhaps be quicker and easier, although maybe not. *See infra* Section IV(F).

[12] Under common law, no rights or duties existed between the tenant and a successor to the original landlord until the tenant attorned to the successor. The payment of rent to the successor generally satisfied the requirement. For those in need of a little trivia, the Statute of Anne of 1705 ended the attornment requirement in England. *See* 4 Ann. c. 16, §§ 9, 10 (Eng.).

after foreclosure.[13]

5. Successor Landlord Protections. After protecting a tenant from being "disturbed" through a foreclosure, an SNDA also usually goes on to protect the Successor Landlord, after foreclosure, against certain problems that might have arisen under the lease before foreclosure. These protections generate most of the sound and fury in SNDA negotiations.

Depending on the lender's approach and the relative strengths of the three parties, SNDA negotiations often produce a three-player game of legal tug-of-war (or ring around the rosy).

Many of the issues of an SNDA also arise when the landlord's financing takes the form of a long-term ground lease from a ground lessor instead of a mortgage on a fee estate. Here, a space user (technically a subtenant) fears that its landlord, the ground tenant, may default under the ground lease. This default could terminate the ground lease and with it the space user's sublease. The space tenant seeks nondisturbance rights against the ground lessor similar to those negotiated between a mortgage lender and a space tenant. In the context of rights against a ground lessor, these agreements often are called "recognition agreements" rather than nondisturbance agreements.[14] They are functionally about the same. Most of the discussion in this Article applies to them with the same force as to SNDAs.[15]

II. LENDER PROTECTION AFTER FORECLOSURE

A lender that agrees to "nondisturb" a tenant after foreclosure usually will insist that if and when the tenant's lease becomes a direct lease between a Successor Landlord and the tenant, the Successor Landlord must be protected against certain claims and problems that may travel with the lease. Those claims and problems are not merely theoretical. If a borrower is in default and knows it is about to lose its property, it is likely to act (and fail to act) in ways that virtually guarantee that some or all of these claims and problems (against which the lender wants to protect the Successor

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[13] *See* Thomas C. Homburger & Lawrence A. Eiben, *Who's On First—Protecting the Commercial Mortgage Lender*, 36 REAL PROP. PROB. & TR. J. 412, 414 (2001).

[14] *See* Vallely Invs., L.P. v. Bancamerica Commercial Corp., 106 Cal. Rptr. 2d 689, 694-99 (Cal. Ct. App. 2001).

[15] This Article does not, however, seek to identify differences between mortgage loan nondisturbance agreements and ground lease recognition agreements. The latter topic is generally disregarded.

Landlord) will arise. These claims and problems fall into three possible categories, each discussed in greater detail below.

1. Landlord-Tenant Conspiracies. The first category of potential problems for a Successor Landlord after foreclosure could be called "Landlord-Tenant Conspiracies." In each Landlord-Tenant Conspiracy, the lender fears that the landlord and the tenant may scheme together against the lender to do something to impair the future rental flow from the lease and hence the value of the lease (and the project) after a future foreclosure.

The landlord (borrower) might know that foreclosure is imminent and it might want to extract whatever quick benefit it can from the property now. Perhaps the tenant compensates the landlord or its principals, or gives them a pro-landlord lease amendment at another location.

In any event, the landlord gets some benefit from the tenant and leaves the lender with the resulting mess after foreclosure—the "scorched earth" theory of lender relations. A lender wants an SNDA to protect it from these problems. To the extent that an SNDA gives a lender that protection, this Article refers to those protections as "Landlord-Tenant Conspiracy Prevention."

2. Lender-Tenant Risk Shifting. The second category of lender protections in an SNDA creates more controversy and may be harder for a lender to defend. Here, the lender seeks to shift a risk or a problem to the tenant (away from a Successor Landlord) after foreclosure ("Lender-Tenant Risk Shifting"). Instead of the Successor Landlord's being responsible for some problem or issue that belonged to the landlord before foreclosure, the lender seeks to shift the burden to the tenant.

3. Post-Foreclosure Lease Improvement. The third category of lender protections is one that any major tenant will typically regard as egregious: the lender seeks to improve the terms of the lease after foreclosure ("Post-Foreclosure Lease Improvement"), for the benefit of the Successor Landlord. In essence, the lender that made a bad loan tells an innocent (nondefaulting) tenant: "Even though I made a loan premised on the rental contract that you made and lived by both before and during my foreclosure, I still want the right to change your contract to your detriment if a Successor Landlord ever takes title."[16]

Unlike the case in Landlord-Tenant Conspiracy Prevention, under Lender-Tenant Risk Shifting or Post-Foreclosure Lease Improvement, the tenant is innocent. The lease or landlord-tenant law makes the landlord

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[16] *See* Richard M. Frome & Thomas D. Kearns, *There Oughta Be a Law*, N.Y.L.J., Dec. 31, 1991, at 2 (urging statutory nondisturbance protection for commercial tenants).

responsible for the problem, but the lender wants to use the SNDA to make the landlord's defalcation partly or completely the tenant's problem rather than the Successor Landlord's. A strong tenant will typically reject the lender's position regarding every form of Lender-Tenant Risk Shifting or Post-Foreclosure Lease Improvement a lender might propose.

The remainder of this Section II describes in detail the elements and dynamics of Landlord-Tenant Conspiracies, Lender-Tenant Risk Shifting, and Post-Foreclosure Lease Improvement, reviewing the typical battlegrounds and how those battles often turn out in a heavily negotiated SNDA.

A. Landlord-Tenant Conspiracies

Landlord-Tenant Conspiracies all involve some agreement between landlord (borrower) and tenant, probably giving the landlord an immediate benefit but leaving the lender with the resulting long-term mess. In each case, the loan documents will typically prohibit or restrict the borrower from entering into any of these Landlord-Tenant Conspiracies. A lender will, however, fear that the borrower may do so anyway, particularly if the borrower knows it is about to lose the property. Under those facts, a landlord might look for creative ways to pull money out of the property before the inevitable foreclosure. The following are some techniques:

1. Rent Prepayment

The tenant prepays rent for a substantial period, perhaps at a negotiated discount. After foreclosure, the tenant asserts the prepayment against the Successor Landlord and refuses to pay again. The Successor Landlord therefore loses the rental income that the lease would have produced during the period the prepayment covered.

Although lenders legitimately fear excessive rent prepayment, tenants typically hesitate to agree to language in an SNDA that might deprive tenants of the benefit of bona fide prepayments that they might have made, in accordance with the lease, for operating expense escalations, repairs, real property taxes, security deposits, or prepaid rent at the end of the term.[17]

[17] Leases for space in shopping centers often require tenants to make sizable payments for common area maintenance and taxes at the start of each quarter or lease year. If actual costs turn out to be lower, the landlord agrees to refund the difference or credit it to the tenant. Although a lender often will agree to be bound by any such prepayment after foreclosure (i.e., it will not be treated as a Landlord-Tenant Conspiracy), the lender will try to disclaim liability to make any refund to which the tenant may be entitled at the moment of foreclosure (i.e., through Lender-Tenant Risk Shifting the lender will try to shift that

Prepaying for these items, either on a one-time, annual, or quarterly basis, is not unusual and should not be confused with abnormal prepayments made pursuant to some later Landlord-Tenant Conspiracy.

Typically, lenders do not want to see tenants prepay rent more than 30 days in advance, except for bona fide prepayments of the types described in the previous paragraph. At the very least, lenders do not want any Successor Landlord to be bound after foreclosure by any excess prepayment.

2. Secret Amendments or Modifications

The landlord and the tenant agree, without the lender's consent, to reduce the rent to $1.00 per year, or to prohibit the landlord from renting space for retail uses elsewhere in the shopping center. The tenant pays the landlord up front for this benefit. After foreclosure, the Successor Landlord suffers the loss of income that results, but all corresponding benefits—the up-front payment—went to the landlord, who is now out of the picture, perhaps enjoying island life in the Caribbean.

A lender will therefore want a tenant to agree in an SNDA that any amendment requires the lender's consent, or more narrowly, that after foreclosure the Successor Landlord will not be bound by any amendment made without the lender's consent.

3. Unconsented Surrenders or Cancellations

As another Landlord-Tenant Conspiracy, the landlord and the tenant could agree, without the lender's consent, to cancel the tenant's lease if the tenant regards it as above market or no longer desirable. The tenant pays the landlord something for the cancellation, and the landlord keeps that money. After foreclosure, the Successor Landlord is stuck with the consequences: dark space, perhaps a failed shopping center.

As an exotic variation, analytically not too different, the landlord files bankruptcy and rejects the lease (effectively an offer to terminate the lease); the tenant treats the lease as terminated (acceptance of the landlord's kind offer to terminate); and the tenant moves out.[18] In any of these circumstances, the lender reasonably will not want the Successor Landlord to be bound by the lease termination.

Landlord-Tenant Conspiracy Prevention is one of the least controversial

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particular risk of loss to the tenant). This protects the Successor Landlord from needing to "go out of pocket" to take care of the tenant.

[18] The process is described in 11 U.S.C. § 365(a), (h) (1994).

parts of SNDA negotiations. Tenants typically do not seek great freedom to conspire with their landlords against the lender with impunity. Major chain stores and large institutional tenants sometimes do not want to bother with obtaining lender approval for routine lease amendments, but this category of tenant may be relatively unlikely to participate in Landlord-Tenant Conspiracies.[19]

B. Lender Protection: Lender-Tenant Risk Shifting

A lender also will fear the risk that, after foreclosure, the Successor Landlord may face liability for the defaulting borrower's actions and omissions as landlord under the lease that predated the foreclosure. In each case, as part of Lender-Tenant Risk Shifting, the lender will try to shift to the tenant the risk of each of these problems and issues. The following are the basic Lender-Tenant Risk Shifting issues:

1. Loss of Security Deposits

If the landlord stole the security deposit (i.e., the Successor Landlord never received it after foreclosure), the lender typically will want this problem to belong to the tenant rather than the Successor Landlord. In other words, under these facts, the lender and Successor Landlord would be exonerated from any responsibility for the missing money.

Although a tenant will argue that this problem should be the Successor Landlord's risk rather than the tenant's risk, the lender usually wins this argument. Even if the tenant may have justice and fairness on its side, as a practical matter any tenant weak enough to need to deliver a cash security deposit usually also lacks the negotiating strength necessary to win on this issue.

2. Disputes Between Landlord and Tenant

If the landlord and the tenant are, before foreclosure, fighting over building services, alleged landlord defaults, audits of escalation rent, alleged overcharges, and so on, the lender wants the Successor Landlord to be able to take over after foreclosure with a clean slate and have no responsibility to the tenant for any of these matters.

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[19] These tenants sometimes will insist on being able to enter into certain types of noncontroversial amendments without the lender's approval. A lender will often accept this compromise. For example, if a lease amendment does not decrease rent, change the term, or increase the tenant's control over any space outside its premises, and is otherwise entered into at arm's length and in good faith, the lender may agree that it will bind the Successor Landlord after foreclosure, even if the lender did not expressly consent to it.

Again, a tenant will argue that none of this should be the tenant's problem or risk. If the landlord did not perform, the tenant suffered an injury and should be made whole—either by the landlord that caused the injury or by that landlord's successor. Assuming the tenant has paid its rent, it should get the benefits it bought when it made that payment.

As a common negotiated outcome, a lender often will agree that a Successor Landlord will be responsible for some or all of the following: (1) continuing chronic problems, but only by correcting the physical situation and cleaning up any mess that remains, and for any other landlord responsibilities for the problem that might first arise after the date of foreclosure; and (2) certain other defined and limited categories of problems, such as the landlord's failure to build out the space (especially if the lender's loan includes a line item or reserve account earmarked for that purpose).

3. Offsets, Defenses, Etc.—Consequences of Landlord Default

If the tenant can assert any claim, counterclaim, defense, or offset because of the landlord's actions or inactions, the lender will want the tenant to agree not to assert it against the Successor Landlord after foreclosure. This agreement, for example, could preclude the tenant from asserting against the Successor Landlord the right to receive refunds that the previous landlord might have owed the tenant.

Along lines much like those suggested above, the tenant will argue that it should not be forced to waive these offsets and other rights, whether they arose under the lease or under applicable law. Also, in some cases a tenant negotiates a specific right in its lease to a rent concession, abatement, offset, or deduction in a specified or predeterminable amount (such as a rent abatement instead of an allowance for leasehold improvements). In principle, a lender will often agree that a Successor Landlord will live with those provisions, just as it must live with the other economics of the lease.

C. Post-Foreclosure Lease Improvement

Going a step beyond protecting a Successor Landlord from Landlord-Tenant Conspiracies and requiring the tenant to agree to Lender-Tenant Risk Shifting, a lender may also try to include language in an SNDA to make substantive changes in the lease upon any foreclosure (or occasionally, even before foreclosure).[20] The following are some of the more

[20] If the tenant has agreed in the lease to sign an SNDA, the landlord (and by extension the lender) should not assume it can use that obligation as an opportunity to require the

common changes of this type, which this Article has defined as Post-Foreclosure Lease Improvements.[21]

1. Burdensome Obligations of Landlord

In an SNDA, a lender may identify certain types of landlord obligations that are particularly likely to cause future claims, disputes, and liability. The lender then tries to say in the SNDA that the Successor Landlord will have no liability for any of these obligations after foreclosure. Similarly, if the lease gives the tenant any special rights that a Successor Landlord might find painful, the lender can try to use the SNDA to trim back those rights. Obligations and rights of these types could include the following:

a. Representations. Landlord's representations, warranties, and indemnities of any kind;
b. Exclusivity. Rights of exclusive use;
c. Pre-emptive Rights. Rights or options to expand, renew the lease, or purchase the building;[22]
d. Abatement. Rights to abate rent upon a default;
e. Restoration. Obligation to restore after casualty or condemnation; or
f. Termination. Rights to terminate the lease upon a landlord default or in other circumstances.

In each case, the tenant negotiated one or more of these provisions in the lease, but the lender would try to use the SNDA to remove that provision from the lease after foreclosure,[23] for the benefit of any Successor

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tenant to agree to Post-Foreclosure Lease Improvements of the type described here. *See* Hartwig Transit Inc. v. Menolascino, 446 N.E.2d 1193, 1194 (Ill. App. Ct. 1983). In *Hartwig*, the lease contained a clause that subordinated it to the mortgage. The landlord asked the tenant to sign a lease amendment that the landlord described as a confirmation of subordination, as the lease required. The document actually imposed additional requirements and did not include nondisturbance protection. When the tenant refused to sign it, the landlord tried to default the lease. The court concluded that the landlord's proffered document was actually a lease modification, which the tenant could justifiably refuse to sign even though it had agreed (only) to confirm the subordination of the lease. *See id.* at 1194-98.

[21] These changes go beyond the changes implied by Lender-Tenant Risk Shifting, such as possibly absolving the lender from responsibility for construction of the tenant's premises.

[22] As a matter of lease negotiations and lender's lease review and due diligence (but not as a uniquely SNDA-related issue), any purchase option, right of first refusal, or other preemptive right should not apply to a transfer through foreclosure or in lieu of foreclosure.

[23] Any "Post-Foreclosure Lease Improvement" relates to the terms of the lease as

Landlord. The tenant will argue, yet again, that it bought and paid for all these benefits as part of its rent. If the tenant does not get the full benefits under the lease, why should it pay full rent?

2. New Tenant Burdens

Occasionally, a lender tries to use an SNDA as an opportunity to impose new burdens and obligations on the tenant, such as the following:

a. Environmental Issues. Environmental indemnities by the tenant, especially if the lender perceives the tenant's activities as creating environmental issues that the lease does not fully address;

b. Transfer Controls. Tighter restrictions on subleasing and assignment; and

c. Financial Statements. Requirements to deliver financial statements.

Usually these Post-Foreclosure Lease Improvements become effective only after foreclosure and a transfer to a Successor Landlord. Occasionally, lenders try to make these changes effective immediately, as soon as the tenant signs the SNDA. In either case, tenants usually try to reject these substantive lease modifications out of hand. If tenants have any negotiating strength, they typically win that discussion.

3. Exculpation of New Landlord

If the landlord forgot to include a nonrecourse or exculpation clause in the lease, the lender may ask for one to become effective automatically, for the benefit of any Successor Landlord, if and when a Successor Landlord ever takes over the building.[24]

Although this is a change in the lease, even the strongest and best-represented tenant should not object to it, assuming it applies only after a Successor Landlord becomes the landlord. This is because: (1) the lender

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between the Successor Landlord and the tenant after foreclosure. For example, going forward, the lease may no longer entitle the tenant to abate rent if the Successor Landlord defaulted. In contrast, Lender-Tenant Risk Shifting protects the Successor Landlord from abatements arising from the previous acts and omissions of the defaulting former landlord or borrower.

[24] A lender may also wish to include a partial nonrecourse or exculpation clause in the SNDA to limit its obligations under the SNDA even before it takes over the project or becomes the landlord. The Report and Model SNDA provides for lender exculpation after foreclosure and attornment, but not before. The committee did not believe such exculpation made sense under the SNDA itself.

could always achieve exactly the same result by sending a shell corporation subsidiary, instead of the lender itself, to bid at the foreclosure sale and take title;[25] (2) in most cases, the tenant would have readily accepted a single-asset landlord during original lease negotiations;[26] and (3) the foreclosure of the mortgage suggests that the Successor Landlord would, at least temporarily, own the property free and clear, leaving substantial equity to back the Successor Landlord's obligations to the tenant.

III. OTHER ELEMENTS OF AN SNDA

Depending on the circumstances of a particular lease and transaction, a lender may also use an SNDA to resolve certain other matters about the relationship between the lender (or a Successor Landlord) and the tenant. In each case, the lender uses the SNDA to help preserve the stability and reliability of the lease as a source of real estate value, for example:

A. Estoppel Type Assurances

The SNDA may include estoppel type provisions, eliminating the need for a separate estoppel certificate. The use of a single combined document may save paper. Including this provision, however, means that if the tenant likes to negotiate, the lender may obtain neither an SNDA nor an estoppel, whereas the tenant might have been willing to sign a simple estoppel if the lender had not muddied the waters by also requiring an SNDA. Typically, estoppels are easier to negotiate and obtain than SNDAs. A foresightful landlord and its lender can solve all these problems by setting forth in the lease the exact form of either estoppel or SNDA (or a combined document for both) that a tenant must sign, and establishing meaningful remedies if the tenant does not cooperate quickly.

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[25] The lender would also need to assign the loan to the subsidiary before the sale and otherwise assure itself that the subsidiary will be able to make a "credit bid." For an example of the perils that can befall a lender if a creditworthy lender entity assumes liability in acquiring collateral, see *Vallely Invs.*, 106 Cal. Rptr. 2d at 694-99 (creditworthy affiliate of leasehold mortgagee "assumes" lease and later cannot walk away from it because it failed to qualify for the applicable leasehold mortgagee protections).

[26] If the landlord were a single-asset entity, the tenant might have insisted, however, on personal guaranties from the landlord's principals on completion of construction, environmental issues, and similar matters. Most commercial leases contain a so-called landlord-for-the-time-being clause, which releases the landlord from continuing liability upon any transfer to anyone (whether or not either is a single-asset entity). Thus, even if the initial landlord is creditworthy, the tenant has no assurance that this will remain true in the future. The tenant should expect nothing better after foreclosure. But this clause also may create an escape strategy for a Successor Landlord that carelessly took title in its own name.

B. Notice and Opportunity to Cure Defaults

If the landlord defaults under the lease, the lender may want the tenant to agree to notify the lender and give the lender an opportunity to cure the landlord's default. The lender would like as long a period as possible to cure—ideally, an open-ended cure right much like a lender's cure rights under a ground lease. The tenant typically will refuse to give more than 30 days beyond the landlord's cure period, if any. Any such right gives the lender a chance to try to preserve the lease by curing the default, or at least it assures the lender that it will hear about the problem in time to try to make the borrower do something about it.

If the SNDA gives the lender a cure right, such a right will often link to Lender-Tenant Risk Shifting because the parties may agree that if the tenant actually gives the lender notice of a problem the Successor Landlord will be responsible for the consequences of that problem after foreclosure.

Although lender cure rights do have value, the cure periods that commercial space tenants will tolerate are often so short that the cure rights do not help much. Moreover, if a lender ever exercises any cure rights the lender will need to expend money and effort at a time when the prospect of doing so is probably not very appealing. The lender will also fear lender liability claims whether the lender's efforts to cure succeed or fail. In practice, therefore, the right to receive notice of default probably benefits a lender more as a monitoring mechanism than as a real-world lease preservation mechanism.

C. Direct Payment of Rent to Lender

If the landlord defaults under the loan documents, the SNDA often will permit the lender to direct the tenant to pay rent directly to the lender. This right can make it easier for a lender to take control of the rental income in a default and implement a "springing lockbox." It eliminates some possible uncertainty for the lender and future conflicts affecting the tenant. A strong tenant may insist that the lender indemnify the tenant against inconsistent claims by the landlord. Both the lender and the tenant may ask the landlord to join in the SNDA to confirm that the tenant should comply with the lender's notice to pay rent and disregard any contrary instructions from the landlord.

Although a provision of this type is typically noncontroversial, a mortgage lender rarely will rely on it. Instead, the mortgagee usually will try to have a receiver appointed at the earliest possible moment to collect the rents.

D. Clarifications

An SNDA may give a lender an opportunity to resolve any other loose ends or uncertainties that may arise under the lease. As examples, a lender may want an SNDA to include the following:

1. *Notice*. Acknowledgment that the tenant has received notice of the mortgage.

2. *Institutional Status*. Confirmation that the lender qualifies as an "institutional lender," which might be open to doubt with transactions involving older leases and newer lenders.

3. *Clean-Up*. Correction of mistakes in the lease, and clarification of inconsistencies and glitches with other leases in a multitenant project.

4. *More Estoppel*. Estoppel-type assurances about unique factual issues of a particular lease. (For example, did the landlord ever finish the jogging trail that the landlord promised to build within 90 days after the occupancy date?)

5. *Control of Valuable Rights*. A covenant by the tenant to give the lender a copy of any notice to the landlord that could trigger a landlord recapture right or a right for the tenant to go dark, offset rent, or terminate.

The more substantive these clarifications become, the more reasonably the tenant may "just say no." At some point the clarifications simply become Post-Foreclosure Lease Improvement, the piece of any SNDA that any tenant hates most.

IV. SUBORDINATION

Going back to basics, the first issue in any SNDA, and the first word in the name of the document, is always "subordination." But what exactly does subordination mean? And how much should a lender really care about pure subordination in the context of a negotiated SNDA? The following discussion considers these and other related questions.

A. Absent an SNDA, Who is Prior?

In every state, absent agreement to the contrary, the relative priorities of a mortgage and a leasehold interest are determined by the rule of "first in time, first in right." If the leasehold estate is prior to the mortgage, the mortgagee cannot affect the leasehold, even if the mortgagee forecloses.[27]

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[27] State law governs priority of interests in real estate. As a result, the treatment of priority issues varies, or at least some of the nuances vary, by jurisdiction. *See* Homburger, *supra* note 13, at 417. General principles of real estate law do support the result stated in

And if the mortgage is prior to the lease, then a foreclosure on the mortgage can wipe out the lease.

B. Pure Priority: The Regulatory Myth

Sometimes it is said that certain lenders need leases to be subordinate to their mortgages because as a regulatory matter: (1) these lenders can invest only in "first" mortgages; and (2) if a mortgage is subject to prior leases, it is not a "first" mortgage. Proposition "2" (hereinafter referred to as the "Regulatory Myth") is thought to be relevant for regulated lenders—particularly insurance companies—and for mortgage originators that may later want to sell their mortgages to regulated lenders.

Although the Regulatory Myth seems to be accepted as bedrock and as a universal justification for SNDAs, both in the literature and among practitioners, any specific authority for the Regulatory Myth seems to be quite elusive. The Regulatory Myth is instead usually expressed as a statement of fact offered up without citation, as in the following statement from a previous article on SNDAs in this publication:

> A requirement that a tenant subordinate its lease to subsequent mortgages may arise because of federal regulations, state regulations, or both. These regulations require certain lenders to have a first lien on the mortgaged premises. Therefore, if a lease is not subordinated to a subsequent mortgage, the mortgage violates applicable regulations.[28]

In an effort to find just one regulation or other legal authority (whether historical or still in force) to substantiate the Regulatory Myth, my colleagues and I undertook many hours of legal research, using both books and electronic services. We canvassed hundreds of real estate attorneys, asking if anyone knew of any authority of this type. We received many replies, each assuring us that some such authority existed (or once existed) and offering suggestions as to how we might find it. Some thought that the requirement to subordinate leases might have originated in turn-of-the-century opinions of the New York State Attorney General. Others thought the rule had its origins in the investment criteria for New York licensed

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text, and many cases confirm it. As discussed below, even if a desirable lease clearly survives a foreclosure, the mortgagee still may fear that no direct contractual relationship will exist between the Successor Landlord and the tenant, hence motivating an SNDA.

[28] *See* Morton P. Fisher, Jr. & Richard H. Goldman, *The Ritual Dance Between Lessee and Lender—Subordination, Nondisturbance, and Attornment*, 30 REAL PROP. PROB. & TR. J. 355, 372 (1995) (citing no such regulation).

insurance companies. Still others thought that, although the rule existed at one time, it was no longer the rule.

Determined to track down these leads and many others, my colleagues and I called the New York State Insurance Department. We called the New York State Banking Department. We called the National Association of Insurance Commissioners ("NAIC"). In each case, we spoke to regulators and quasi-regulators whose pronouncements and guidelines define the scope of investments that insurance companies and banks may make. We searched the statutes, the NAIC model rules, the case law. We looked high, and we looked low, and we looked every place this legal authority might go. For better or worse, though, we could not unearth a single, specific legal authority to provide (or that ever provided) any support for the Regulatory Myth.

The closest authority on point came in a well reasoned opinion of the New York State Attorney General issued over 100 years before publication of this Article. At the time, the New York Banking Law prohibited state-regulated savings banks from lending against real property that was subject to any prior "incumbrance." The question presented was whether a 21-year lease, with two 21-year renewals, would constitute "an incumbrance . . . such as would preclude a savings bank from investing its money upon a bond and mortgage thereon."[29]

The Attorney General adopted an extremely practical and intelligent approach to answering the question, and concluded that such a lease was "not an incumbrance in the contemplation of this law."[30] The Attorney General noted that the terms of the lease "are very favorable" and "extremely desirable," so that upon a foreclosure, the lease would "enhance instead of depreciate the value of the property."[31]

The Attorney General therefore opined "that the lease in question is not an incumbrance upon the property; that, within the purview of the Banking Law, the property is unencumbered; and that a savings bank would be justified in investing its money in a bond and mortgage thereon."[32]

On its face this 1896 opinion certainly does not support the Regulatory Myth. A believer in the Regulatory Myth might argue, though, that: (a) the opinion implies that some leases might be deemed "incumbrances" if their terms were less favorable than the one considered here; (b) this creates

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[29] 1896 N.Y. ATT'Y GEN. REP., at 171.
[30] *Id.*
[31] *Id.* at 172.
[32] *Id.*

uncertainty about any lease; (c) no one is smart enough to determine which leases are favorable enough to avoid characterization as "incumbrances;" and therefore (d) the safest approach is to assume that all leases are incumbrances rather than to try to make a judgment that any particular lease is "good" (not an "incumbrance") or "bad" (an "incumbrance"). The 1896 opinion hardly seems to dictate or even encourage such a timid approach. To the contrary, it is usually not hard to determine whether a particular lease is "good" or "bad" in the context of underwriting a specific mortgage loan intended to be backed in part by the income from that lease. The 1896 opinion establishes a perfectly practical roadmap for dealing with prior space leases.

Another New York State Attorney General opinion issued a few years before sheds further light on how the Attorney General interprets the term "incumbrance" and whether it would include a typical commercial lease.

In an 1891 opinion interpreting the same provisions of the New York Banking Law, the Attorney General was asked to determine whether the existence of a use restriction would render property "incumbered" and hence impermissible as collateral.[33] The Attorney General concluded that the statute did not necessarily bar investment in an otherwise "first" mortgage encumbering any real property that was subject to any form of title exception, however minor it might be.

Instead, the only incumbrance that would jeopardize the legality of a loan would be one that "subjects the fee to the property to some contingency or is of such a nature as to form a lien or claim which would be prior to the claim or lien of a . . . mortgage taken by the bank, or which in any way would tend to endanger the security of a . . . mortgage on the property. . . .:"[34]

The Attorney General approached the issue in a practical and reasonable way—again, very far from the literal and hypertechnical approach that the Regulatory Myth suggests. Far from automatically denying "first

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[33] See 1891 N.Y. ATT'Y GEN. REP., at 52. The current Banking Law states: "A savings bank may invest in . . . [b]onds and mortgages and notes and mortgages on improved real property, including leasehold estates [but not] upon the security of a mortgage which is not a first lien." N.Y. BANKING LAW § 235(6) (McKinney 2002). The statute says nothing about whether the existence of a prior lease prevents a mortgage from being a "first" mortgage. Until it was amended in the Eighties, this section of the Banking Law required not only that collateral be "improved" but also that it be "unencumbered." That latter requirement was amended out of the statute in 1983. Omnibus Banking Act (L. 1983, c. 1, sec. 12).

[34] 1891 N.Y. ATT'Y GEN. REP., at 52.

mortgage" status to any mortgage that is subordinate to other title exceptions, such as leases, the Attorney General instead was quite willing in the 1891 opinion to analyze in a rational and thoughtful way the precise title exception that would have priority over the mortgage, and decide whether that particular title exception would somehow jeopardize the security of the mortgage. If it did not jeopardize the security of the mortgage, then it could remain in place as a prior title exception, without the property's being deemed encumbered.

The 1891 opinion suggested that banks should make decisions of this type on a rational, case-by-case, basis as follows:

> If the restriction is not in the nature of a condition, and no forfeiture can result from its non-observance, and the fee to the property can in no way be taken from the owner by reason of non-observance of the restrictions, or the title disturbed thereby, and the value of the property will not be reduced in consequence thereof, then such a restriction would not be an incumbrance, I think, within the meaning of the banking law, but . . . the effect of the restriction should be, however, taken into account in determining the value of the property.[35]

The approach that the New York State Attorney General took in analyzing these questions about a century ago seems remarkably practical, logical, and correct. It is also quite remarkable to see how widely it varies form the formalism suggested by the Regulatory Myth, even though the retellers of that Regulatory Myth often allude vaguely to old New York State Attorney General opinions.

The purpose of the "permitted investment" statutes was to protect money deposited with (for example) savings banks from being endangered by loans on "unsafe securit[ies]."[36] Although a prior lien presents the possibility of foreclosure on a property and hence a risk to the mortgage if the obligation is not paid, no such risk arises from leases.

The New York Insurance Law contains similar restrictions on pemissible mortgages, again to safeguard against risky investments:

> The mortgaged property shall be subject to no prior lien, except a first mortgage and liens for non-delinquent ground rents, taxes, assessments and similar charges. There shall be no condition or

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[35] *Id.* at 53.
[36] *Id.* at 52.

> right of re-entry or forfeiture not insured against under which the mortgage can be cut off, subordinated or otherwise disturbed.[37]

As in the New York Attorney General's 1891 and 1896 opinions described above, the legality of a prior title exception depends on whether it can impair the security of the mortgage.

An early case on the "permitted investment" rules indicates that the courts take an approach similar to that taken in the Attorney General opinions described above. In *In re New York (Tunnel Street),* more commonly known as the "Tunnel Street case," the issue was whether an easement to construct a "tunnel street" 150 feet below ground level, even though it would not physically injure the property, would severely reduce the value of the property by rendering it unmortgageable by any regulated lender. Citing the 1891 Attorney General opinion, the court held:

> It is certainly not every easement affecting real estate which is to be considered an incumbrance within the prohibition of the statutes. . . . If the incumbrance is not in the nature of a condition from which a forfeiture may result, or if the easement is not one which . . . reduces the value of [the owner's] remaining interest in the land, the property cannot be said to be so "incumbered" as to forbid the corporation . . . to loan upon it.[38]

This analysis further supports the proposition that, absent a specific regulation or statute requiring it, a typical commercial space lease is not the kind of interest burdensome enough to endanger a loan and thus require subordination.

Later cases have done little to clarify or shape these ideas or help them evolve, particularly in a way that might offer any support to the Regulatory Myth.[39] Much of the judicial discussion of banking law "permitted investment" rules appears in the law governing trustees' permitted investments, because until that law was reformed, trustees were specifically permitted to invest in the same securities as savings banks.[40] Those cases tend, however,

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[37] N.Y. INS. LAW § 1404(a)(4)(A)(i) (McKinney 2002). The quoted language relates to permitted investments by non-life insurers.

[38] *In re* New York (Tunnel Street), 144 N.Y.S. 1002, 1003 (App. Div. 1913), *aff'd* 212 N.Y. 547 (1914).

[39] For example, *see In re* Gillespie, 173 Misc. 591, 594 (N.Y. Sup. Ct. 1940) (city tunnel construction on adjacent condemned property held not to impair value of plaintiff's property; citing "Tunnel Street" for the proposition that "[t]he existence of the easement is not a substantial incumbrance").

[40] *See In re* Wilson's Will, 127 N.Y.S.2d 876, 878 (Surr. Ct. 1953) ("Prior to 1950,

to focus on fiduciary duties. Any issues about "first liens" arose only incidentally, or were left open.[41]

Where does this leave us? Both the New York Banking Law and the New York Insurance Law say that no prior "liens" may exist for a regulated lender to make a mortgage loan. Both are silent, though, on the treatment of leases or other encumbrances. The NAIC model uses similar language, requiring only that an insurance company be the "holder of the first lien."[42] Again, that leaves open the implications of prior leases.

A typical commercial lease does not have the characteristics of a lien. It will not imperil the security of a mortgage. It will not cut off subordinate estates. There is no reason to think it amounts to an "encumbrance" of the type that would prevent a mortgage from being a first mortgage. In the absence of any apparent authority, the Regulatory Myth appears to be nothing more than an urban legend of the real estate bar.

If the Regulatory Myth really were a correct statement of the law, what would it imply about title exceptions other than leases? If a prior lease prevents a mortgage from being a first mortgage, why shouldn't prior easements or use restrictions have the same effect? But no one has ever (to the author's knowledge) suggested that prior easements or use restrictions would prevent a mortgage from being a "first mortgage." What would make them any different from leases?

Section 111 of the Decedent Estate Law and Section 21 of the Personal Property Law authorized, among others, investments by fiduciaries 'in the same kind of securities as those in which savings banks. . . are by law authorized to invest the money deposited therein.'").

[41] For an example of this type of ultimately unsatisfying discussion, see Farr v. New York Trust Co. (*In re* Accounting of New York Trust Co.), 52 N.Y.S.2d 654, 655 (App. Div. 1945), *rev'd*, 294 N.Y. 596 (1945). In *Farr*, the trustees made an investment relating to a golf course subject to numerous restrictions on use, sale, and purchase that were "a disadvantage to foreclosing mortgagors." Although the Appellate Division affirmed an earlier ruling for the trustees (so one court, at least, found even these significant restrictions inadequately burdensome to "encumber" the property), the only comment on the encumbrance issue came from the dissent. The dissent insisted that the property was "encumbered" within the meaning of the statute: "[T]he decision appealed from failed to properly evaluate the onerous nature of the present restrictions which might seriously reduce the value and salability of the land. Such restrictions were not in the same category as the minor ones found in [Tunnel Street]." This case was overturned on appeal but the court declined to express an opinion "[a]s to whether th[e] property was unencumbered in a legal sense," deciding the case on other grounds. *See* Farr v. New York Trust Co. (*In re* Accounting of New York Trust Co.), 294 N.Y. 596, 610 (1945).

[42] *See* MODEL LAWS, REGULATION AND GUIDELINES § 15(A)(1), § 28(A)(1) (Nat'l Ass'n of Ins. Comm'rs 2002) ("an insurer may acquire. . . obligations secured by mortgages on real estate. . .but a mortgage loan which is secured by other than a first lien shall not be acquired unless the insurer is the holder of the first lien.").

Assuming that the Regulatory Myth is in fact only a myth, a lender need not worry, as a regulatory matter, about allowing its mortgage to be subordinate to prior leases. As part of its underwriting process, of course, the lender should pay attention to what those leases say. Particular terms of particular leases may make them so undesirable that the lender should insist on subordinating them to the mortgage,[43] but that would be the exception rather than the rule.

C. Automatic Cut-Off Risks

The issue of subordination takes on particular importance in some states, including California and Utah, where the courts have concluded from time to time, rather unfortunately, that any foreclosure will automatically cut off subordinate leases, whether or not a mortgagee wants that result.[44] Automatic cut-off states typically allow mortgagees to enforce their rights through a power of sale. The courts in these states sometimes say that the mere proper exercise of that power terminates any subordinate lease and there is nothing a lender can do about it. On the other hand, nothing in these cases negates the ability of the parties to resolve the problem by contract, which is, of course, where a SNDA (or some substitute contractual arrangement) enters the discussion.

For example, in *Dover Mobile Estates*, a space lease in California was expressly subordinate to all present and future mortgages and deeds of trust. When the lender held a trustee's sale under the deed of trust, a California

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[43] For example, if the lease requires the tenant to pay only a dollar a year in rent, or prohibits the landlord from leasing the remainder of an office building for any office-related use, or gives the tenant an option to purchase for $1.00, a lender should legitimately be quite concerned about the lease. Subordinating the lease to the mortgage may help solve the problem.

[44] *See* Principal Mut. Life Ins. Co. v. Vars, Pave, McCord & Freedman, 77 Cal. Rptr. 2d 479 (Ct. App. 1998); Dover Mobile Estates v. Fiber Form Prods., Inc., 270 Cal. Rptr. 183 (Ct. App. 1990); Consol. Realty Group v. Sizzling Platter, Inc., 930 P.2d 268, 272 (Utah Ct. App. 1997). In California, "[a] valid foreclosure terminates all interests in the real estate junior to the mortgage being foreclosed, but it does not terminate interests senior to the mortgage." *Vallely Investors L.P.*, 106 Cal. Rptr. 2d at 695 citing Sumitomo Bank v. Davis, 6 Cal. Rptr.2d 381 (Ct. App. 1992), and R-Ranch Mkts. #2, Inc. v. Old Stone Bank, 21 Cal. Rptr.2d 21 (Ct. App. 1993). Although these cases seem to provide for the automatic termination of leases, they still leave open the possibility that a lender can preserve leases by proceeding strategically or by negotiating appropriate contractual protections. Each case is extremely fact specific. To say that any particular state is categorically an automatic cut-off state usually represents an overstatement and an overgeneralization from the facts of a particular case.

court held that this extinguished the lease automatically.[45] When the new landlord accepted rent from the tenant, the court said this created only a month-to-month tenancy, absent further agreement.[46] Soon after the parties created this new tenancy, the tenant terminated it by notice to the new landlord. The court validated the termination.[47]

Thus, even though the court acknowledged that the lease was "of 'supreme importance to [the foreclosure purchaser's] decision to purchase,'" the Successor Landlord could not enforce the lease against the tenant after the tenant terminated the monthly tenancy upon thirty days' notice.[48] Although the lease gave the lender the express right to elect to make the lease superior to its mortgage, the lender actually never had exercised that option before the trustee's sale.[49]

If the *Dover Mobile Estates* lease or a separate SNDA had contained a well-drafted attornment clause that would survive termination or extinguishment of the lease through a trustee's sale, the tenant would have been contractually bound to honor its lease obligations for the balance of the full term and attorn to the Successor Landlord, if the Successor Landlord so requested.[50]

In other states, such as New York and New Jersey, if a lender wants to terminate (or cut off) a subordinate lease, the lender must name the tenant as a party defendant in the foreclosure action.[51] If the lender does not take

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[45] *See Dover Mobile Estates*, 270 Cal. Rptr. at 187.
[46] *See id.* at 187.
[47] *See id.*
[48] *Id.* at 185.
[49] *See id.* at 184.
[50] The subordination language in the *Dover Mobile Estates* lease provided:

> Subordination of Lease to Loans. Tenant agrees that this Lease shall be subordinate to any mortgages or deeds of trust in the nature of mortgages that may hereafter be placed upon the premises, to any and all advances made or to be made under them, to the interest on all obligations secured by them, and to all renewals, replacements, and extensions of them; provided, that if any mortgage[e] or beneficiary elects to have this Lease superior to its mortgage or deed of trust and gives notice of its election to Tenant, then this Lease shall be superior to the lien of any such mortgage or deed of trust and all renewals, replacements and extensions thereof, whether this Lease is dated or recorded before or after the mortgage or deed of trust.

Id. at 184.
[51] *See* World Traditions, Inc. v. DeBella, 720 A.2d 671, 674 (N.J. Super. Ct. Ch. Div. 1998); Dime Sav. Bank v. Montague St. Realty, 664 N.Y.S.2d 246 (Ct. App. 1997). *See also* Homburger, *supra* note 13, at 416 (concluding that New Jersey and New York follow a "pick and choose" rule, allowing a lender to terminate an unfavorable lease while keeping a favorable one).

that step, then the foreclosure does not terminate the lease.[52]

As a result, the law of the state where the property is located may help a lender decide whether the lender wants its mortgage to be prior or subordinate to leases, or particular leases. If the lender subordinates to lease(s), the lender loses the hypothetical opportunity to cherry-pick in the foreclosure process, but also assumes the risk of unintentionally losing rental income in an automatic cut-off state if the lender proceeds carelessly with its foreclosure.

In a so-called automatic cut-off state, a lender can use an SNDA as a tool to protect the lender from the risk of losing a desirable lease. As an alternative in an automatic cut-off state, or if the lender cannot or does not want to rely on the effectiveness of the SNDA to prevent an alleged automatic cut-off, the lender simply may want the lease to be prior to the mortgage. Even then, the lender may still want an SNDA simply to confirm matters and to try to achieve the following three goals of any other SNDA: Borrower-Tenant Conspiracy Prevention; Lender-Tenant Risk Shifting; and Post-Foreclosure Lease Improvement. In that case, pure priority has no meaning whatsoever. The SNDA governs the parties' rights and obligations; priority makes no difference.

The preceding discussion demonstrates the need to consider state-by-state issues in deciding how to deal with SNDAs, and the practical unimportance of pure priority and subordination once the parties negotiate their rights and obligations in an SNDA.

Particularly in a so-called automatic cut-off state, a lender may want to defer the question of relative priority to a later date. It can achieve this by including provisions in an SNDA for an existing lease, in the mortgage itself for future leases, or in the borrower's standard form of lease (also for future leases), that allow the lender unilaterally to elect to subordinate its lien to any given lease at any time.[53] By including these provisions, the lender always has the option to subordinate its mortgage and avoid the entire issue at any time up to foreclosure. Sample language to this effect appears in Exhibit A, under the heading of "Optional Priority."[54] Such language protects the lender's interest and preserves flexibility. By making

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[52] Occasional New York cases suggest that as a matter of foreclosure procedure the lender must name all subordinate tenants and terminate all subordinate leases—it has no choice. This would be the functional equivalent of an automatic cut-off rule. Such cases are, however, aberrational and unlikely to be followed. *See* JOSHUA STEIN, NEW YORK COMMERCIAL MORTGAGE TRANSACTIONS § 12.06 (Aspen Law & Business 2002).

[53] *See Principal Mut. Life Ins. Co.*, 77 Cal. Rptr. 2d at 484-85.

[54] *See infra* p. 773.

priority optional, the lender eliminates any risk of an inadvertent automatic cut-off.[55] Language of this type may give a lender the best of both worlds. Because it also gives the tenant the worst of both worlds, a tenant with any negotiating strength should reject it.

The Restatement of Mortgages suggests that unless a lease grants an optional priority right, a mortgagee may have no unilateral right to subordinate the mortgage to the lease, because a unilateral subordination by the mortgagee may impair the tenant's position by depriving the tenant of the possible benefit of being wiped out in foreclosure if the tenant's lease is above market and burdensome.[56] The author would argue that this alleged "benefit" to a tenant is quite illusory for the following reasons.

Outside an automatic cut-off state, any mortgagee can defeat this tenant benefit by not naming the tenant in the foreclosure action. Even in an automatic cut-off state, the lender could assure itself of being subordinate, again defeating the tenant's alleged benefit, merely by refinancing its own loan with an entirely new loan secured by a newly recorded mortgage. The author sees no reason to think that any mortgagee should be unable to subordinate its lien unilaterally to the claims of any tenant. The author would therefore reject the Restatement's position.

D. Conflicts Regarding Casualty and Condemnation

Subordination of a lease to both the lien and the terms of any mortgage should resolve any inconsistencies between the lease and the mortgage regarding application of condemnation awards and casualty insurance proceeds ("loss proceeds"). In a conflict, the "prior" party should win its

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[55] In *Dover Mobile Estates*, the lender had this flexibility, but forgot to use it. Too much flexibility sometimes creates new ways to make mistakes. The lender would have achieved a better result if it simply had subordinated to the lease at closing, the mechanism that this Article ultimately recommends.

[56] *See* RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.7 cmt. d (1996). This comment includes the following discussion and illustration:

> [I]n some cases the advancement of priority may actually be disadvantageous. . . . In such a case, the subordination is not effective without the consent of the party being advanced.
>
> [For example, in a foreclosure, under applicable law] Tenant has the right to become a party to those proceedings and, because of its junior status, to have Tenant's lease terminated upon completion of the foreclosure. Tenant desires this result, but Mortgagee does not. In an attempt to prevent this result and preserve the lease, Mortgagee informs Tenant that Mortgagee is subordinating its lien to Tenant's lease. Tenant refuses to consent to this action. The subordination is ineffective.

claim to loss proceeds. Some regard this as a lender's main practical justification to require leases to be subordinate to mortgages.

The author has been advised informally that at least one major insurance company generally subordinates the lien of its mortgages to all approved leases, though in many cases not to the tenants' interests in casualty insurance or condemnation proceeds.[57] Can a mortgagee selectively subordinate to only certain parts of a lease? The answer may depend on what the lease says, perhaps whether the lease uses language such as that suggested in Exhibit A.

E. Adverse Effect of Lost Priority?

In the real world, what does a lender lose if a lease "primes" the lender's mortgage? The New York Court of Appeals has said that once a lender has "nondisturbed" a tenant, such an agreement "effectively render[s] the tenant's rights to possession under the lease superior to the [mortgagee's] rights under the mortgage."[58] One might ask why it is necessary to go through the dance of subordination followed by nondisturbance. It should also be noted, though, that this particular dance is only a small, noncontroversial part of any SNDA. Moreover, the nondisturbance and recognition that a lender offers a tenant is often conditioned in several important ways. Negotiation of those conditions is where the parties most often fall out of step.

F. Interaction with Lease Enforcement

In structuring their relationship with tenants, lenders may want to know they can use the foreclosure process to terminate a defaulted tenant without the need to exercise conditional limitations, bring nonpayment or other enforcement proceedings, or exercise other remedies under landlord-tenant law. A lender might think foreclosure will be faster and simpler than lease-enforcement remedies in states where landlord-tenant law has become a minefield festooned with elaborate procedural rules and requirements that often allow any tenant to turn any lease enforcement proceeding into full-blown, slow litigation.[59]

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[57] According to industry lore, informally reconfirmed with appropriate company personnel, Teachers Insurance and Annuity Association—College Retirement Equities Fund generally follows this policy.

[58] KVR Realties, Inc. v. Treasure Star, Inc., 445 N.E.2d 641, 642 (N.Y. 1983) (mem.).

[59] Many property owners in New York, and their counsel (including the author), would say that New York has achieved this dubious result. Tenants and their counsel might disagree.

Of course, foreclosure may not be a great remedy either. If the tenant whose lease was terminated by foreclosure does not voluntarily vacate the leased premises, the Successor Landlord after foreclosure still will need to bring a dispossess proceeding or an action for ejectment to remove the tenant physically and recover vacant possession after the foreclosure.

V. ATTORNMENT

In another element of any SNDA, along with subordination and nondisturbance, the tenant agrees to attorn to any Successor Landlord as landlord in the event of foreclosure. This creates privity of contract between the lender (for the benefit of the Successor Landlord, once identified) and the tenant. Attornment assures the lender that the Successor Landlord can enforce the contractual provisions of the lease after foreclosure and altogether avoids issues about whether the tenant and the Successor Landlord have a direct contractual relationship. The attornment components of an SNDA and the clarity and certainty they can provide are the second reason, after subordination, why lenders like these agreements. Tenants also appreciate the certainty that a covenant to attorn can create, and often insist that the lender agree to notify the tenant when a transfer of title has occurred.

The specific language and terms of the attornment provisions will govern how this process works and its exact effect on the existing lease. For instance, a recent California case states that if the attornment clause is subject to some precondition (such as giving a notice), the Successor Landlord must satisfy that precondition before the attornment clause can bind the tenant. If no precondition exists, then the attornment is automatic upon foreclosure, and the existing lease continues automatically between the tenant and the Successor Landlord, unless the Successor Landlord is entitled to, and does, elect otherwise.[60]

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[60] *See* Goldilocks Corp. of S. California, Inc. v. Ramkabir Motor Inn, Inc., No. 00-55924, 2002 WL 24562 (9th Cir. 2002). The bank foreclosed and became the new landlord. *See id.* at *1. The bank informed the tenant that the tenant was bound by the lease. *See id.* The tenant later decided it didn't like the lease, and sued the bank on a theory of detrimental reliance and misrepresentation, arguing that the bank's actions (in telling the tenant that it was bound by the lease) "caused it to continue to stay at the property rather than search for more economical lease terms elsewhere." *Id.* The court held that under the attornment language in the original lease between the tenant and the former landlord, the lease survived the foreclosure. *See id.* at *4. Upon foreclosure, attornment was automatic because there was no requirement for the bank to notify the tenant of an attornment for it to be effective. *See id.* at *3. Because the attornment clause already required the tenant to continue the lease, the tenant could not have detrimentally relied on the bank's statements saying the

A. Termination Prevention

If a tenant agrees in an SNDA to attorn to the Successor Landlord, this should preclude the tenant from arguing for creative theories of lease termination upon foreclosure. Such an agreement is especially critical to purchasers at foreclosure in automatic cut-off states, such as California, to avoid the risk of being unable to enforce a lease, under the theory that the foreclosure simply terminated the lease.

Although New York is not an automatic cut-off state, at least one New York case requires the lender to name and serve subordinate tenants in any foreclosure action, under the dubious theory that the lender must do this to maximize the value of the property to a third party at a foreclosure sale.[61] If that case correctly describes the law in New York (which it probably does not), then New York is effectively an automatic cut-off state. A strong attornment covenant will protect the lender, after foreclosure, from such rulings.

In *Miscione v. Barton Development Co.*, an attornment clause in the lease itself, rather than in an SNDA, protected the Successor Landlord.[62] After a foreclosure sale, the tenant tried to cancel the lease and move out, arguing that the foreclosure had extinguished the lease. The court concluded that the tenant had agreed in the lease to attorn to a Successor Landlord upon a foreclosure. The attornment clause stated that the Successor Landlord did not need to give notice to the tenant to effectuate an attornment. The only conditions precedent to attornment were that the Successor Landlord acquired the premises and accepted the premises subject to the lease.[63] Because Successor Landlord had done exactly that, the condition in the lease had been satisfied, and the tenants were obligated to attorn to the Successor Landlord.[64] On the other hand, sometimes courts

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tenant must continue the lease. *See id.* The tenant's theories of misrepresentation and detrimental reliance, if accepted, would imply that in any business dispute: (1) each party can assume the truth of all claims and theories its adversary might assert; and (2) if any of those claims or theories turn out to be false (and the plaintiff can show it "relied" on them), the adversary must pay. That is hardly a correct statement of how the real world works or should work.

[61] *See* Nat'l Bank of N.A. v. Gloucester Equities, Inc., 372 N.Y.S.2d 348 (Sup. Ct. 1975). During the real estate depression in the 1990s, the ruling in this case was rejected, almost without discussion, when raised by borrower's counsel in a foreclosure the author handled.

[62] 61 Cal. Rptr. 2d 280 (Ct. App. 1997).

[63] *See id.* at 288.

[64] *See also Goldilocks Corp. of S. California Inc.*, 2002 WL 24562.

have concluded that a Successor Landlord cannot rely upon, and cannot enforce, a provision in a lease that generally requires tenants to attorn to Successor Landlords after foreclosure.[65]

B. Theoretical Question

Why should a Successor Landlord need a separate attornment agreement to create a direct lease with the tenant after foreclosure? If the fee estate changed hands by delivery of a deed, the new owner would not need a separate agreement with the tenant to create privity between the tenant and the new landlord.[66] Why should a conveyance by foreclosure produce a different result?

The distinction may reflect the fact that a deed, unlike a foreclosure, is not legally capable of terminating a subordinate estate; therefore, any grantee under a deed continues to have privity of estate with the tenant.[67] Assuming the lease contains standard language saying it inures to the benefit of the landlord's successors and assigns, the new landlord will have privity of contract with the tenant as well, thus giving the landlord the ability to enforce the contractual covenants of the tenant.

Why should a foreclosure action that does not name the tenant produce a different result? It should not, except when by statute or common law a foreclosure automatically terminates leases whether or not the lender names tenants, thus cutting off the privity of estate and privity of contract necessary for the Successor Landlord to enforce the lease.

VI. SUBORDINATION: PRACTICAL NEEDS OF THE PARTIES

A. Lender's Point of View

Any discussion of SNDAs starts with a fairly straightforward proposition for the mortgage lender. As described above, the lender simply wants all leases to be subordinate to the lien of its mortgage. If the leases are subordinate, without more, then the lender knows that the foreclosure process will either automatically extinguish each lease or let the lender decide selectively which leases it wants to keep.

But is that what lenders really do? In the real world, lenders rarely, if

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[65] *See* Homburger, *supra* note 13, at 434-35 (discussing HRPT Advisors, Inc. v. MacDonald, Levine, Jenkins & Co., P.C., 686 N.E.2d 203, 210-11 (Mass. App. Ct. 1997)).

[66] *See* Glidden v. Second Ave. Inv. Co., 147 N.W. 658 (Minn. 1914) (stating that attornment after a sale is not necessary); N. Pac. Ry. Co. v. McClure, 81 N.W. 52 (N.D. 1899) (finding that conveyance or assignment does not require attorning by the tenant).

[67] *See Glidden*, 147 N.W. at 659; *McClure*, 81 N.W. at 53.

ever, want to cut off a lease in a foreclosure. Generally, mortgages do not just go into default for no reason. Generally, a loan goes into default because vacancy rates rise in the market or in a particular building and, as a result, rents and property revenues drop. Or the borrower may be overleveraged, so slight variations in rental income or interest rate may prevent the borrower from paying its debt service.

Under these facts, both landlords and lenders prefer to hold on to any legitimate tenant that pays rent. Of course, occasionally a small tenant impedes the leasing of a large block of space, or an otherwise desirable tenant pays rent so far below market value that the lender would prefer to see the tenant gone. Those instances, though theoretically possible, are relatively rare, especially in times of real estate distress.

Aside from the economic reality that lenders rarely want to terminate leases after foreclosure, lenders must also consider the timing of any such termination. Even if a lease is subordinate, a Successor Landlord will not necessarily be able to obtain vacant possession the day after taking title to the property.

Even after the foreclosure proceeding grinds to a conclusion, the Successor Landlord will probably still need to initiate and complete a landlord-tenant dispossess proceeding. If the tenant decides to fight, the Successor Landlord might not obtain possession until several months or even years after completing the foreclosure action. That eviction litigation will probably raise complicated and expensive factual issues about which the Successor Landlord will have relatively little information and no cooperation from the prior landlord who probably does have the facts. If the Successor Landlord ever wins the litigation, the tenant's lease may have expired or the tenant may have taken advantage of the weak market to enter into a new lease. The Successor Landlord will probably find that the likely grief and expenditure of time just do not justify the effort to terminate a bona fide commercial lease—even if "subordinate"—and obtain possession after foreclosure.

B. Treatment of Casualty and Condemnation Proceeds

Perhaps lenders care about subordination because it may resolve inconsistencies between the lease and the loan documents regarding the treatment of insurance proceeds and condemnation awards. As a practical matter, just how important is that? The following discussion examines the issue and both a lender's and a tenant's concerns.

1. Lender-Tenant Negotiations

When a tenant agrees that its lease will be subordinate to a mortgage, it accepts the mortgagee's right to determine the application of loss proceeds. The tenant also accepts the risk that the loss proceeds will go to repay the loan rather than to restore the tenant's building.

A strong tenant will insist that the lease, not the mortgage, govern the application of loss proceeds even if the lease is subordinate to the lien of the mortgage. At that point, when coupled with full nondisturbance and mutual attornment, the technical subordination of the lease becomes meaningless. The lender has given up even the right to assert priority as to the treatment of loss proceeds.

Of course, if the lender forecloses and the lease becomes a direct lease between the Successor Landlord and tenant, then the mortgage vanishes, and the terms of the lease apply between the tenant and the Successor Landlord. Absent special treatment in the SNDA, the Successor Landlord would simply be bound by the lease, even as to loss proceeds. Priority of the now-extinguished mortgage would become irrelevant. So a lender that cares a great deal about what its mortgage says on the use of loss proceeds should not just rely entirely on the SNDA. Such a lender must instead confirm that it can live with the terms of the lease standing on their own, or must try to repair those terms as part of a Post-Foreclosure Lease Improvement.

2. The Risks of Inconsistency

A lender prefers to avoid any inconsistency between the lease and mortgage regarding loss proceeds. So too should a landlord or borrower, potentially caught between two conflicting contractual obligations. Being forced to comply with inconsistent obligations is a bad thing—litigation waiting to happen. Even the tenant would prefer to achieve complete consistency to avoid future disputes and uncertainty.

On the other hand, will the practical benefit of eliminating any such inconsistency exceed the cost of the exercise? As a business decision, a practical lender may decide simply to live with the risk of inconsistencies between the mortgage and lease regarding application of loss proceeds.[68] Most standard leases do not impose heavy restoration obligations on the landlord anyway. Major tenants probably will refuse to accept an SNDA

[68] A portfolio lender will have more flexibility to make this judgment than a lender that intends to securitize its loan.

that purports to eliminate whatever restoration obligations the tenant negotiated.[69]

On a portfolio-wide basis, a lender may conclude that it is cheaper and easier to deal with possible inconsistencies of this type only if and when the problem ever arises (sometime in the distant and hypothetical future) than to negotiate it up front with every tenant in an SNDA. Even if a casualty or condemnation occurred and the lease and the mortgage were inconsistent, the interests of mortgagee and tenant are, as a practical matter, not typically at odds. Both parties usually like to see buildings restored and occupancy and rent recommence,[70] even though lenders always say they want to have the option to apply loss proceeds to their debt.

C. "Cleaning Up" "Bad" Leases After Foreclosure

As a practical matter, lenders may want tenants to subordinate to mortgage liens so that a Successor Landlord can reposition the property after foreclosure by getting rid of undesirable leases. In theory, a foreclosing lender may have a grand new plan for the property, and subordination of the leases will facilitate that plan.

On the other hand, lenders who have just taken back properties in foreclosure do not typically want to enter the real estate development and management business. They usually just want to get rid of the property quickly and in a way that minimizes loss.[71] They have the same concerns as anyone purchasing the property at a foreclosure sale or acquiring it by deed in lieu of foreclosure. Successor Landlords typically want to know (1) that rental income will be preserved, (2) the scope of the parties' obligations under the lease, and (3) rights of a successor in title.[72] Ideally, in the event of foreclosure, any Successor Landlord wants to tell a subsequent purchaser that its responsibilities are limited to cashing rent checks.

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[69] Major tenants that insist on restoration when they negotiate their lease will probably take the same position when they negotiate their SNDA. The lender will probably accept, or be forced to accept, the restoration obligations.

[70] In most cases, restoration probably increases the likelihood that the borrower will repay the loan.

[71] Historically, lenders have been inclined to dispose of delinquent loans at significant discounts rather than infuse new capital into a multitenant real estate project. This is the case even when a project has one or more credit tenants and the discounted sale exacerbates losses. *See* David P. Kassoy, *The Tension Between Lenders and Credit Tenants Over SNDAs*, 23 L.A. LAW. 16, 19 (Jan. 2001).

[72] *See* Homburger, *supra* note 13, at 412.

1. Effect on "Perfectly Good" Tenants

Even more significantly, the lender may want the Successor Landlord to have the right to throw out an otherwise good tenant—who is not in default and did nothing wrong—merely because the lender made a bad loan and later decides the lender does not like a particular tenant or the terms of its lease. In other words, the lender wants flexibility and expects to obtain it—potentially at the cost of an innocent tenant. Even if a tenant is creditworthy, a lender may decide that the terms of its lease are overly tenant-oriented.[73]

Although in theory flexibility is always great, particularly after foreclosure, in the real world, rental income from existing leases is the surest source of real estate value. In practice, after foreclosure lenders rarely want to terminate arm's-length leases with real commercial tenants who are paying their rent and are not in default, even if the leases are highly tenant-oriented. This will be true even if the lender conceivably has some newer and better concept for the project—a shift upscale or downscale or to some other mix of tenants. In such an instance, a right to relocate the tenant may perhaps be more valuable than the ability to terminate the lease, although SNDAs rarely, if ever, give a Successor Landlord any such relocating right.

2. Fraudulent or Stupid Leases

At the time of loan closing, if the borrower entered into a sweetheart lease with his brother-in-law in which the landlord has not received fair equivalent (or even appropriate) value for the leasehold interest conveyed, or if the borrower entered into a lease that is not fraudulent or conspiratorial but merely stupid, the lender should identify the problem through preclosing due diligence and require express subordination in these cases or reduce the loan amount accordingly.

Bad leases such as these, if made after recording the mortgage, should automatically be subordinate, unless the mortgage says otherwise.[74] A lender must not agree in the loan documents automatically to nondisturb all future leases. This is rarely a problem because most lenders will agree to

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[73] *See* Kassoy, *supra* note 71, at 19.

[74] *See* New York City Cmty. Pres. Corp. v. Michelin Assocs., 496 N.Y.S.2d 530, 534 (App. Div. 1985). Before foreclosure, the tenant and the landlord agreed to a 20-year lease at $1.00 per month. The court reasoned that because the landlord and the bank agreed to use an assignment of rents as security for the mortgage, the lease contravened the terms of the mortgage. The court held that the lease was fraudulent, collusive, and subordinate to the mortgage, and was terminated by the foreclosure.

nondisturb only future leases that meet certain criteria including maximum term, minimum rent, arm's-length unaffiliated tenants, and use of a preapproved standard form. The lender may also require its specific approval of each nondisturbed lease.

Except for the relatively rare fraudulent or conspiratorial lease, very few leases are so bad or so stupid (even if extremely tenant-oriented) that a lender would actually want the ability to terminate them through foreclosure. As an example of such a lease, the author recently encountered a lease that the borrower signed after the closing without the lender's consent, and under which the borrower agreed to allow a tenant tremendous rent abatements if the landlord did not complete construction on time. The landlord and borrower finished construction at least a year late and faced several years of rent abatements. When the lender began foreclosure, the lender named the tenant as a defendant and tried to terminate the lease.[75]

3. Leverage

Of course, at the time of foreclosure, a lender might be able to use the threat of lease termination as a lever to extract higher rent or to remove burdensome landlord obligations or restrictions from a lease with an otherwise innocent tenant. Even that hypothetical justification for requiring subordination rarely arises.

D. Tenant's Views

Without an SNDA, upon foreclosure, the lender can in theory terminate any lease that is subordinate, whether because of lien priority or because of contractual subordination provisions in the lease or a separate agreement. A tenant wants to prevent this outcome, hence its desire for nondisturbance.

1. Risk Assessment

Assuming an arm's-length lease, how often do lenders really try to terminate existing leases (even if below market) via foreclosure? Is this truly a problem when existing rental income is usually the surest source of real estate value? Should tenants lose sleep over this risk and rely on SNDAs as a form of sleeping pill?

Although the preceding discussion may suggest that tenants should not worry about nondisturbance, a tenant usually will refuse to take any chances. If a tenant's lease is subordinate, a foreclosure could mean the end

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[75] Ultimately, the borrower refinanced the property long before the lender could complete the foreclosure.

of its business at that particular location. In general, a tenant, particularly an anchor tenant paying below-market rent or any tenant with a significant investment in leasehold improvements, will have more to lose by going without an SNDA than does a lender.

2. Effect of Shifting Bankruptcy Law

Most distressed real estate changes hands not by foreclosure, but through a deed in lieu of foreclosure or prepackaged plan of bankruptcy reorganization.[76] Typically, neither of these transactions will imperil leases, even subordinate ones.[77] Now that New York has a more simplified and streamlined foreclosure process,[78] and if bankruptcy law continues to develop in a way that discourages single-asset real estate cases,[79] mortgage lenders may begin to find foreclosure more attractive and practical. Lenders may then prosecute more foreclosures to completion, producing greater jeopardy to tenants that are subordinate but lack SNDA protection.

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[76] For troubled properties in New York State, the demise of the gains tax and the new nonjudicial foreclosure statute, N.Y. REAL PROP. ACTS. LAW Art. 14 (McKinney 2002), may decrease the need for prepackaged bankruptcies while increasing the feasibility of deeds in lieu of foreclosure. Whether this is true will not be known until the next prolonged downturn.

[77] An SNDA might, however, define foreclosure broadly enough to include a deed in lieu of foreclosure or a transfer through a bankruptcy plan of reorganization. If the debtor sells the property through a Bankruptcy Code section 363 sale, the sale may function much like a foreclosure sale, with potentially the same effect on subordinate leases.

[78] In 1998, the New York Legislature enacted a nonjudicial foreclosure statute to facilitate some foreclosures on commercial real estate in New York. *See* N.Y. REAL PROP. ACTS. LAW Art. 14 (McKinney 2002). Whether the statute will achieve that goal outside the context of "friendly foreclosures" of commercial projects within the scope of the statute is not yet known. *See* STEIN, *supra* note 53, at ch. 16.

[79] It is the author's general sense that Congress and the courts are today less tolerant of single-asset real estate cases than they were during the real estate depression of the early Nineties. For example, in 1994 Congress adopted special expedited procedures for these cases, at least where they involve less than $4,000,000 of secured debt. 11 U.S.C. § 362(d)(3). The fact that the dollar cap has not (yet) been raised may suggest some limits to Congress's impatience with these proceedings. *See* Baxter Dunaway, The Law of Distressed Real Estate, § 29:3 (West Group 2002) ("The 1994 Reform Act, which made sweeping amendments to the Bankruptcy Code, was enacted to address many of the perceived new abuses brought on by the increased bankruptcy filings, especially in connection with single-asset real estate cases. The 1994 Reform Act contains several provisions that benefit real estate lenders."). For a discussion of unresolved issues in the area of single-asset real estate, *see* Sarah Robinson Borders, *Hot Topics With Respect to Real Estate Bankruptcy Issues*, 470 PRACTISING L. INST.: COM. REAL EST. FIN. 611 (2001).

VII. JUDICIAL RESPONSE TO LANDLORD-TENANT CONSPIRACIES

As described above, lenders often require SNDAs because lenders fear getting stuck as the "bagholder" after the consummation of a Landlord-Tenant Conspiracy. The concern is not unreasonable. In fact, Landlord-Tenant Conspiracies occasionally do happen. How have the courts handled them? How often have lenders been stuck with artificially devalued leases because of borrowers' desperate pre-foreclosure tactics?

The following discussion demonstrates that: (a) Landlord-Tenant Conspiracies do occur; (b) the courts can and do protect lenders from the more egregious Landlord-Tenant Conspiracies; but (c) such protection is by no means assured and will vary with the particular facts and judicial discretion. The following discussion goes through each of the Landlord-Tenant Conspiracies listed in a typical SNDA, and summarizes a handful of cases that have considered whether a lender will be bound by such a Landlord-Tenant Conspiracy even without a protective SNDA. In almost all the cases discussed here, the courts protected the lender against Landlord-Tenant Conspiracies based on one theory or another.

A. Rent Prepayment

In *Dime Savings Bank v. Montague Street Realty Associates,* a tenant had prepaid about a year's rent but the court required the tenant to pay a second time to the Successor Landlord.[80] The story began in 1982, when the landlord leased certain real property to European American Bank ("EAB") for a five-year term without renewal options. The lease was expressly subordinate to all present and future mortgages.

In 1987, Dime Savings Bank ("Dime") made a mortgage loan to the owner. The lender promptly recorded its mortgage. The mortgage prohibited the owner and mortgagor from accepting prepayments of rent and provided that any new leases were subject and subordinate to the mortgage.[81]

In 1992, EAB and the owner amended the 1982 lease to extend its term for five years and to modify other provisions. In particular, EAB agreed to, and did, prepay in 1992 all the rent for the entire first year of the extended term (June 1, 1993 to May 31, 1994, a total of $160,000 in rent).[82]

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[80] 686 N.E.2d 1340 (N.Y. 1997).
[81] *See id.* at 1341.
[82] *See id.*

In early 1993, shortly before the Dime's prepaid-rent period began, the owner defaulted on its mortgage. The lender obtained appointment of a receiver, and the receiver demanded that EAB pay the receiver the same rent that EAB thought it had prepaid. EAB refused. EAB argued that it was not bound by the covenant in the recorded mortgage prohibiting prepayments of rent because the 1992 agreement merely continued the original lease, which predated the Dime mortgage.[83]

The court rejected that argument, finding that the so-called amendment was in fact a new lease. The court stated, "Because the new contract postdated the *Dime* mortgage and because pledged collateral cannot be impaired by a postdated agreement by the mortgagor-landlord, whatever right EAB had pursuant to that contract was subordinate to the terms of the mortgage."[84]

A federal district court in New York similarly held that when a recorded mortgage restricted the landlord from entering into leases without the landlord's consent, any future tenant was automatically on notice of that requirement.[85] Again, pure priorities solved the Landlord-Tenant Conspiracy problem. Once the mortgage was recorded, the entire world was on notice of its terms.

Some older cases suggest that courts might enforce Landlord-Tenant Conspiracies against the lender after foreclosure, even if the tenant's conduct looks suspicious. In *Bank for Savings in City of New York v. Shenk Realty & Construction Co.*, the landlord and the tenant agreed to decrease the monthly rent from $75 to $70 if the tenant prepaid 12 months of rent. The receiver tried to increase the rent back to $75.[86] The court ruled in favor of the tenant, reasoning that there was no showing that the agreement was made in anticipation of a foreclosure; therefore, the agreement was bona fide and binding until the entire lease was terminated by a sale at foreclosure.[87]

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[83] *See id.* at 1342.

[84] *Id.*

[85] *See* Resolution Trust Corp. v. 53 W. 72nd St. Realty Assocs., 91 Civ. 3299, 1991 WL 156260, *3 (S.D.N.Y. 1992). *See also* U.S. v. Bedford Assocs., 491 F. Supp. 851 (S.D.N.Y. 1980) (finding that a lender's right to approve new leases was a matter of public record; tenants bound); First Nat'l Bank v. Coast Consol. Oil Co., 190 P.2d 214 (Cal. Dist. Ct. App. 1948).

[86] 37 N.Y.S. 2d 597, 598 (App. Div. 1942).

[87] *See id.* at 598. The case focused on the powers of a receiver to collect rent and enforce leases and concluded that the receiver lacked the power to rewrite leases. The issue was not so much whether a Successor Landlord should be bound by the prepayment.

Similarly, in *Martinique Realty Corp. v. Hull,* a New Jersey tenant claimed to have prepaid all rent for the entire term of a five-year apartment lease.[88] The subsequent purchaser was bound by the prepayment.[89] Of course, a purchase is far from analogous to a foreclosure under a prior existing mortgage, but *Martinique Realty Corp.* does at least evidence some willingness to tolerate suspicious transactions under circumstances in which a court could have come out the other way.

New Jersey courts later took a more lender-oriented approach in *Kirkeby Corp. v. Cross Bridge Towers, Inc.*[90] Here, the landlord offered tenants deals such as six months' rent for the price of five[91]—paid in advance, on the eve of foreclosure.[92] The court concluded that for periods after foreclosure the tenants still owed rent, in the full stated amount, to the Successor Landlord because the individual leases each specifically prohibited the prepayment.[93] The court stated that the tenants had notice of the recorded mortgage and the prepayments were made at their peril.[94]

In another case, *Grether v. Nick* the landlord collected a large prepayment of rent, and used it to improve the building.[95] The court reasoned that "where the mortgagee enjoys the full benefit of the advanced payment, and it was made in good faith and not for the purpose of working a fraud, a court of equity should not work oppression by requiring its payment a second time."[96] The court held the Successor Landlord bound by the prepayment, based on the theory that the Successor Landlord had the benefit of the improvements funded by the prepayment.[97]

From that starting point, any other tenant-oriented court probably would have little trouble finding that some other prepayment somehow benefitted

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[88] 166 A.2d 803 (N.J. Sup. Ct. App. Div. 1960).

[89] *See id.* at 808. Under these circumstances, the subsequent purchaser is somewhat analogous to a foreclosing mortgagee, although lacking any previously recorded interest in the real estate.

[90] 219 A.2d 343 (N.J. Super. Ct. 1966).

[91] *See id.* at 345.

[92] *See id.*

[93] *See id.* at 348.

[94] *See id. See also* Dickens v. Smith, 180 N.Y.S.2d 565, 567 (N.Y. Mun. Ct. 1958) (finding that the tenants who prepaid rent had constructive notice of the terms of the mortgage, which prohibited prepayment); Green Mountain Bank v. Bruehl, 536 A.2d 554, 557 (Vt. 1987) (stating that one year's lease extension and prepayment negotiated after filing of foreclosure action did not bind mortgagee).

[95] 213 N.W. 304, 305 (Wis. 1927), *aff'd on reh'g*, 215 N.W. 571 (Wis. 1927).

[96] *Grether*, 215 N.W. at 573.

[97] *See id.* at 572-73.

the lender and thus should bind the Successor Landlord. In effect, the *Grether* court would let the borrower impair the lender's collateral (the future rental income) with impunity, as long as the borrower could show that it meant well and did something with the money that could be deemed to improve the lender's collateral.

The possibility of outcomes such as this one motivates lenders to require SNDAs simply to avoid the need to argue that a particular Landlord-Tenant Conspiracy should not bind the Successor Landlord.[98]

B. Amendments and Extensions

Several courts have held that when a landlord delivered a mortgage (which the lender recorded) and the landlord later amended or extended leases, the foreclosure wiped out both the amendments and the extensions,[99] stripping the lease back to its condition before the amendments or extensions. These courts treated the extension agreements as new leases that postdated the recorded security instrument and were therefore subject and subordinate to the mortgage even though the lease being amended predated the mortgage.[100]

In *United Welfare Fund-Security Division v. LAP Realty Corp*., the original two-year lease entered into on August 15, 1968 predated the second mortgage dated November 30, 1973.[101] The tenant claimed that he assigned his interest on September 30, 1973 to a certain Ms. Pal for herself and as trustee to the Pal Family Trust. But the trust was not established until December 26, 1979. The tenant also converted the two-year lease into a 99-year lease with 99-year renewals.

Perhaps motivated by the almost farcically abusive nature of the scheme, the court held that because of the discrepancy between the date of

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[98] *See* Home Life Ins. Co. v. O'Sullivan, 136 N.Y.S. 105 (App. Div. 1912). The Supreme Court (New York's general trial court) held that a tenant who had prepaid rent for the last month of the lease still had to pay rent to the receiver. *See id.* at 107. The tenant's only remedy was to sue the previous landlord. *See id.* at 108. Similarly, in Prudence Co. v. 160 West Seventy-Third St. Corp., 183 N.E. 365, 367 (N.Y. 1932), the New York Court of Appeals (New York's highest court) suggested that if a landlord and tenant conspired to reduce rent or prepaid rent in anticipation of foreclosure, a court may have the power to set aside the landlord-tenant agreement.

[99] *See Dime Sav. Bank*, 664 N.Y.S.2d at 249; *Resolution Trust Corp.*, 1991 WL 156260 at *3; *Bedford Assocs.*, 491 F. Supp. at 867.

[100] *See Dime Sav. Bank*, 664 NB.Y.S.2d at 249; *Resolution Trust Corp.*, 1991 WL 165260 at *3; *Bedford Assocs.*, 491 F. Supp. at 866. *See also R-Ranch Mkts. #2, Inc.*, 21 Cal. Rptr. 2d at 608.

[101] *See* N.Y. L.J., May 15, 2002, at col. 3.

the assignment and the creation of the Pal Family Trust and the totally incredible testimony of the tenant, the amendment was "created no earlier than December 26, 1979 [the date of the creation of the trust], that it was back-dated for the sole purpose of undermining [mortgagee's] rights under the mortgage, and that it [was] invalid."[102]

In a California case, *R-Ranch Markets #2, Inc. v. Old Stone Bank*, the court took this rationale a step further.[103] There, the landlord granted a deed of trust, which the lender recorded. Later, the landlord amended, but did not extend, a previous lease to let the tenant make certain assignments without landlord consent.[104] The court decided that a trustee's sale under the deed of trust wiped out this amendment.[105]

In reaching its conclusion, the *R-Ranch* court relied heavily on *First National Bank v. Coast Consolidated Oil Co.*[106] The facts of the two cases differed because in *First National Bank* the modification was an extension agreement entered into a few hours before the foreclosure sale.[107] But, the *R-Ranch* court concluded that the extension agreement was really a new lease.[108] By treating it as a new lease, the question of the relative rights of lender and tenant became a simple question of timing. If the lease was made after the mortgage or deed of trust was recorded, the court could treat it as subordinate.[109]

The *R-Ranch* court concluded that the policy underlying the rule in *First National Bank* was "to protect lending institutions from fraudulent amendments to leases which would encumber the value of their acquired property."[110] Adopting a different approach might discourage lending because lenders "would have no assurances that the borrower and senior leaseholder would not drastically reduce the value of the lease, thereby reducing the value of the property and security."[111] In other words, the courts should protect lenders merely because they are lenders and even though they have available to them a range of perfectly feasible measures

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[102] *Id.*
[103] 21 Cal. Rptr. 2d 21 (Ct. App. 1993).
[104] *See id.* at 22.
[105] *See id.* at 24.
[106] 190 P.2d 214 (Cal. Dist. Ct. App. 1948).
[107] *See id.* at 215. The amendment also said the tenant "was relieved of all liability for said defaults and the said lease was declared to be in full force and effect . . . ." *Id.*
[108] *See R-Ranch*, 21 Cal. Rptr. 2d at 23.
[109] *See id.*
[110] *Id.* at 24.
[111] *Id.*

by which they can protect themselves. One could also say that the court protected the lender because the mortgage was recorded and the tenant should therefore be bound by it under ordinary principles of real estate law (a proposition that does not always seem to apply in this area).

The *R-Ranch* case, as reported, does not indicate whether the tenant actually knew that the landlord had mortgaged the property after the parties signed the 1982 lease. Therefore, the court does not address the burden its decision might place on tenants by forcing them to check the status of mortgages before amending their leases.

This pro-lender decision is not universally applied, to the dismay of lenders and their counsel. Perhaps its logic applies only in title theory states, based on the theory that the trustee's deed upon foreclosure relates back to the recording of the deed of trust. In other words, in title theory states, the trustee's deed conveys the state of title held that the trustor holds at the time of the deed. Therefore, anything that takes place after that time is of no effect as against the grantee of that deed. But the logic of the case would also seem to apply more generally, even in lien theory states.

C. Lease Cancellations

In addition to the Landlord-Tenant Conspiracies described above, the courts have been willing to protect lenders after foreclosure against bad-faith lease cancellations made on the eve of foreclosure. For example, in *Poughkeepsie Savings Bank v. R & G Sloane Manufacturing Co.*, the tenant had received notice that the rents under the lease were assigned to the lender, and had in fact been paying its rent directly to the lender.[112] Just before the lender foreclosed, the landlord and tenant entered into an agreement terminating the lease without the lender's consent. The court held that the lender could recover unpaid rent from the tenant. The purported lease cancellation could not eliminate the tenant's duty to pay rent, because the landlord and tenant could not agree to cancel the lease without

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[112] 445 N.Y.S.2d 560, 562 (App. Div. 1981). The court distinguished the lender's interest under a conditional assignment of rents in a mortgage (to which New York Real Property Law § 291-f (McKinney 2002) would apply) from a present outright assignment. Today, lenders' counsel generally structure the assignment of rents and leases (typically in a separate instrument) as a *present* assignment, with a license back to the assignor to collect the rents until an event of default, rather than a conditional assignment. *Poughkeepsie Savings Bank* suggests that this absolute rather than conditional assignment may not protect lenders against Landlord-Tenant Conspiracies after a tenant has actual notice of such assignment, but before the tenant has been directed to pay rent to the lender (and before considering the effect of a section 291-f notice). For more on section 291-f see the discussion *infra* Section XI about alternatives to an SNDA.

the lender's consent.

D. Overview: Judicial Treatment of Landlord-Tenant Conspiracies

The preceding discussion demonstrates that courts can and do protect lenders from Landlord-Tenant Conspiracies, although not necessarily always. Even if a court is willing to protect a lender from an adverse lease amendment resulting from a Landlord-Tenant Conspiracy, though, if the parties change the economic terms of the lease pursuant to procedures set forth in the lease itself, the courts will probably treat that change as part of the lender's risk and not as a Landlord-Tenant Conspiracy at all.[113] Also, if a landlord-tenant transaction seems customary, routine, and entered into in good faith, courts will not necessarily set it aside even if a lender can argue it somehow violates a mortgage of which the tenant had actual or constructive notice.[114]

This residual uncertainty partly explains why lenders require Landlord-Tenant Conspiracy Prevention measures in SNDAs, and do not want to rely on the courts to protect them against Landlord-Tenant Conspiracies.

E. Comparison to Lost Priority for Superior Mortgages

Comparing the treatment of prior leases to the treatment of prior mortgages may be useful, or at least interesting. When a second mortgage

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[113] *See* E. N.Y. Sav. Bank v. 520 W. 50th St. Inc., 608 N.Y.S.2d 974 (Sup. Ct. 1994). There, the mortgagor's board of directors (a cooperative housing corporation) reduced the tenants' rent during foreclosure. The receiver tried to increase the rents, but the court held that the mortgage did not prohibit rent reductions. *See id.* at 975. Instead, it prohibited modifications in the leases that reduced rent. The court held that rent fluctuations in cooperative apartment buildings occur pursuant to the lease itself, rather than as some modification of the lease; therefore, fluctuations in rent were built into the structure, and the lender could not complain. *See id.* at 976. But the lender could foreclose and wipe out the leases, so the tenants' victory was rather short-lived.

[114] *See, e.g.*, Cent. Sav. Bank v. Chatham Assocs., Inc., 388 N.Y.S.2d 908 (App. Div. 1976), in which the court held that even though the tenant had subleased the property to another tenant, who again subleased the property to another party for a higher price than the rent payable to the receiver, the receiver could not increase the rent. *See also* Flatbush Sav. Bank v. Levy, 109 N.Y.S.2d 247, 248 (Sup. Ct. 1951) (holding that after tenant paid $320 security deposit for the last four months of the lease, the lender's receiver could not collect the last four months of rent); Stellar Holding Corp. v. Berns, 257 N.Y.S. 369, 369 (App. Term 1932) (foreclosing mortgagee bound by lease provision allowing three-month security deposit to be applied to last three months of rent, even though mortgagee never received the deposit). *But see* Home Life Ins. Co. v. O'Sullivan, 136 N.Y.S. 105, 107 (App. Div. 1912) (allowing a receiver to recover rent for final months from tenant, even though tenant paid a security deposit to be applied to final months' rent).

is recorded after a first mortgage, the law establishes a certain relationship between the liens. In general, the second mortgagee can safely assume that the prior mortgage is limited to the obligations the first mortgage described or initially secured. In other words, the second mortgagee can assume that the first mortgage secures only payment of a certain principal amount at a certain interest rate with a certain maturity date. If the borrower and the first mortgagee later agree to increase the burden that the first mortgage imposes on the real estate (such as by doubling the interest rate), then the incremental burden will lose its priority and become subordinate to the second mortgage.[115]

Why can't a prior lease and its subsequent amendment be treated the same way? In other words, even if the lease is recorded first, then the mortgage, and then the lease is amended, why doesn't the amendment make the whole lease, or at least the amendment, become subordinate to the recorded mortgage?

One can argue that a lease is functionally just like a mortgage—both are nothing more than prior claims to the value (whether possessory value or liquidation value) of real property. If the prior tenant and the owner agree to reduce the rent to one dollar per year, all they accomplish is increasing the burden that the prior lease imposes on the real estate. Under established black letter law, if the lease were a mortgage, any such change would partly or wholly subordinate the (former) first mortgage to the subordinate mortgage. Why not the same result for a lease, or at least for the incremental burden created by a lease amendment? Some of the cases discussed in this Section suggest that courts sometimes do take this approach, but not necessarily always. Lenders do not like the uncertainty.

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[115] *See* RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.3(b) (1996) ("If a senior mortgage or the obligation it secures is modified by the parties, the mortgage as modified retains priority as against junior interests in the real estate, except to the extent that the modification is materially prejudicial to the holders of such interests [subject to certain possible exceptions]."). *See also* Shultis v. Woodstock Land Dev. Assocs., 594 N.Y.S.2d 890, 892 (App. Div. 1993) ("[I]f the modification [of the senior mortgage] is such that it prejudices the rights of the junior lienors or impairs the security, their consent is required. Failure to obtain the consent . . . results in the modification being ineffective as to the junior lienors and the senior lienor relinquishing to the junior lienors its priority with respect to the modified terms. While this sanction ordinarily creates only the partial loss of priority noted above, in situations where the senior lienor's actions in modifying the note or mortgage have substantially impaired the junior lienors' security interest or effectively destroyed their equity, courts have indicated an inclination to wholly divest the senior lien of its priority and to elevate the junior liens to a position of superiority.") (citations omitted).

F. Another View on Landlord-Tenant Conspiracies

A lender might take another view of this entire picture. The lender might decide that (1) in most of the reported cases the courts have protected lenders against Landlord-Tenant Conspiracies, and (2) the risk of Landlord-Tenant Conspiracies is probably not very high to begin with because most tenants would not enter into these arrangements.

Therefore, if a lender made a portfolio-wide business decision not to address Landlord-Tenant Conspiracies in SNDAs, while still protecting itself with appropriate provisions in the mortgage documents, how often would that lender actually suffer loss from Landlord-Tenant Conspiracies? Would that hypothetical future loss exceed the expense and delay incurred in negotiating SNDAs up front, as part of the closing process, with all tenants? How many tenants, particularly creditworthy and substantial tenants, would knowingly prepay their rent for several years or engage in other Landlord-Tenant Conspiracies?[116]

Contrary to the suggestions in the last few paragraphs, though, most institutional lenders are concerned about the risk of Landlord-Tenant Conspiracies. They may, however, be willing to address those risks through a mechanism other than SNDAs, if they are satisfied that such a mechanism is available and relatively reliable. Some suggestions along those lines are offered in Section XI of this Article.

VIII. LENDER-TENANT RISK SHIFTING

Lender-Tenant Risk Shifting finds its way into court even less frequently than Landlord-Tenant Conspiracies. The area does not invite judicial action unless a lender and a tenant agree to some form of Lender-Tenant Risk Shifting contractually. This area does not raise issues of fraud, abuse, conspiracy, and the like, which may tempt a court to use its equitable powers to protect the lender from an evil scheme. Instead, Lender-Tenant Risk Shifting simply allocates, by a contract, a certain identified risk of loss.

When a landlord receives but misapplies (steals) a tenant's security deposit, the facts could be described either as a Landlord-Tenant Conspiracy, much like a prepayment of rent, or as an example of Lender-Tenant Risk Shifting, in which the issue becomes who bears the risk of loss. In a handful of cases, courts have been willing to shift this risk of loss to the lender, at least when the tenant's security deposit did not appear to be

[116] In *Dime Savings Bank*, an institutional tenant did exactly that, for a year anyway.

abusive.[117] In other words, courts were willing to treat the tenants as more innocent than the lenders and force the lenders to bear the risk of a lost security deposit.

A New York statute provides a rare example of a form of Lender-Tenant Risk Shifting provided for by law. New York General Obligations Law Section 7-105(2) states that a grantee of commercial real property (including through foreclosure) becomes "responsible" for security deposits when the prior owner turns over the deposits to the new owner.[118] This statute implies that in New York no such responsibility would exist for the Successor Landlord if the prior owner (the foreclosed-out borrower) failed to turn over the security deposits.[119] Under these facts, the former owner would remain responsible for the security deposits.[120] If the Successor Landlord does not receive the security deposits, this statutory language would suggest that a tenant could not sue the Successor Landlord for the missing security deposits or probably even offset against rent for the amount of the missing security deposit. Any such offset would effectively make the new owner responsible for the security deposits. Therefore, New York has by statute shifted the risk of lost security deposits to the tenant.

Aside from stolen security deposits, the primary focus of Lender-Tenant Risk Shifting relates to the risk that before foreclosure the landlord or borrower has somehow defaulted under the lease and the tenant has claims or offsets against the landlord or borrower. After foreclosure, the lender does not want the Successor Landlord to be responsible for these claims and offsets, and thus shifts to the tenant the risk of loss resulting from the landlord's mismanagement and lease default before the foreclosure.

The author's limited research disclosed no case law or statute that would, absent contractual provisions on point, shift any such risk to the tenant. The area is primarily contractual and perhaps the most contentious battlefield in any SNDA negotiations.

One common negotiated resolution consists of the following. The tenant will agree that the Successor Landlord generally is not responsible for any problems that result from the borrower's lease default before foreclosure. If, however, the tenant gave the lender notice of the problems

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[117] *See supra* note 105.

[118] *See* N.Y. GEN. OBLIG. LAW § 7-105(2) (McKinney 2001).

[119] Failure to turn over security deposits to a receiver or purchaser at foreclosure is a misdemeanor. *See* § 7-103. *But see also* §§ 7-107 and 7-108 (imposing liability on a grantee of multifamily residential property if the prior owner fails to turn over security deposits and invalidating any tenant waiver of this liability).

[120] *See* § 7-105(2).

with the landlord when those problems arose, then the tenant can assert against any Successor Landlord any claims, liability, or offsets arising from those problems but only to the extent arising from and after the date of the tenant's notice to the lender.

This negotiated resolution helps protect a lender or Successor Landlord from being blindsided by unexpected claims from the tenant after foreclosure. It also gives the lender the opportunity (but also imposes on the lender the burden of perhaps needing) to step in and solve the problem when it starts, rather than getting involved only when the problem has snowballed.

If a lender agrees that a Successor Landlord will be responsible for preforeclosure problems of which the lender has received notice, then the lender should at a minimum include in its loan documents a set of covenants that require the borrower to perform its obligations under all leases and trigger a default (subject to a cure period) if any tenant claims a lease default against the borrower. The lender also will want to limit any Successor Landlord's exposure to tenants' claims, such as by limiting claims to direct and actual losses without running the risk of being responsible for indirect or consequential losses, or punitive damages.

As another possible negotiated outcome, particularly as it relates to the landlord's build-out obligations[121] under the lease, the SNDA may preserve the tenant's claims against the Successor Landlord, but where appropriate, limit the tenant's remedy to an offset, perhaps with a dollar or percentage cap on the amount that the tenant may offset against rent each month. This way, the tenant still receives the benefit of what it negotiated in the lease, but the process takes a bit longer and the Successor Landlord preserves some minimum rent stream. The parties share the loss in that neither tenant nor lender is the sole "bagholder" at the end of the day.

In practice, this may sound very fair, but a lender or Successor Landlord probably will realize that a loss incurred over time is still a loss, mitigated only slightly by the time value of money. A careful tenant will be equally aware of the time value of money and will insist on an interest factor. So the arrangement ultimately amounts to a loan from the tenant to the

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[121] The landlord's build-out obligations will vary depending on the circumstances. Sometimes, the landlord literally agrees to build out (construct tenant improvements in) the tenant's space, either partially or completely. As an alternative, the landlord may agree to contribute a specified dollar amount toward the tenant's cost of performing its work. A free rent period at the beginning of the lease also may give the tenant an equivalent benefit. All these circumstances are functionally equivalent, although a conservative lender may regard a performance obligation as more burdensome and more likely to produce disputes than a mere payment or "free rent" obligation.

Successor Landlord and is probably a waste of time (unless the Successor Landlord has internal institutional constraints that make it difficult to advance more funds but easy to tolerate a partial offset against rents).

As another possibility, the SNDA may not obligate the Successor Landlord to cure any landlord defaults, but may give the tenant the right to terminate the lease if the Successor Landlord chooses not to assume and perform the defaulting landlord's obligations. A mere termination right, though, gives the tenant only a crude and generally useless threat against any Successor Landlord, especially if the tenant has made a significant investment in the space. The tenant may try to require the Successor Landlord to reimburse the tenant's investment upon such a termination, but few lenders would agree to any such requirement.

The tenant usually has the stronger side of the argument regarding this type of Lender-Tenant Risk Shifting. Nevertheless, lenders often win and Successor Landlords oten do not need to cure past landlord defaults. Even so, the author is not aware of any case in which a Successor Landlord has tried to disclaim substantial obligations of the former landlord, such as an obligation to build out the space, and yet collect full rent from that tenant. On theories of unjust enrichment alone, a Successor Landlord should not get the economic or rental value benefit of leasehold improvements that the tenant initially paid for but were ultimately intended to be paid for by the landlord, directly or indirectly.

In many cases, if a lender doesn't press the tenant too hard on Lender-Tenant Risk Shifting, any such concession might not be all that burdensome to a lender. Most foreclosures take time. During that time, a receiver will often operate the property. With any luck, the receiver will deal with any tenant's complaints long before a Successor Landlord actually takes title.

IX. POST-FORECLOSURE LEASE IMPROVEMENT

As is Lender-Tenant Risk Shifting, the area of Post-Foreclosure Lease Improvement is entirely contractual. It raises many of the same issues and negotiations as Lender-Tenant Risk Shifting. A few areas of Post-Foreclosure Lease Improvement are unlikely to be controversial, such as asserting that any Successor Landlord will automatically have no liability beyond its interest in the property.

On the other hand, to the extent that a tenant with any negotiating strength cares about the benefits that it negotiated in its lease (including, for example, recourse to a creditworthy landlord for such matters as environmental indemnities and build-out obligations), the tenant will hesitate to trade away those benefits to create an easier life for a Successor Landlord.

Stronger tenants usually (and usually successfully) take the position that a lender should either approve or disapprove a lease, and then a Successor Landlord should live with the lease that the lender approved.

X. SNDA NEGOTIATIONS

The following discussion examines the dynamics and tensions of SNDA negotiations, with some suggestions on how landlords, lenders, and tenants can simplify and speed up those negotiations.

A. Stuck Between Two Third Parties

Institutional lenders and major tenants often expect to "have it their way." This expectation often extends to SNDAs. Therefore, in negotiating an SNDA, the landlord often is stuck between two potentially intransigent third parties.[122] In many cases neither lender nor tenant acknowledges that it needs the other, placing the landlord in the middle. As a result, SNDA negotiations can be slow and not much fun for the landlord and its counsel.

B. "I Give Up—Let Them Fight by Themselves!"

The landlord's counsel may be tempted to let the lender and the tenant negotiate directly, thereby getting the landlord's counsel out of a frustrating loop. There is certainly some logic, and more temptation, to letting the lender's counsel and the tenant's counsel go at it by themselves. The landlord's counsel can, however, play a mediating and calming role. The landlord's counsel can also push along the SNDA, a negotiation that the lender and the tenant may not consider to be as important or urgent as the landlord believes it to be. The right strategy probably will vary from case to case, depending on who is involved and what time periods are running.

C. The Last Piece of the Puzzle?

SNDA negotiations are at their worst when the landlord already has signed both the loan documents and the lease, then must bring the lender and the tenant together to agree on the SNDA. A landlord should try instead to obtain agreement on an SNDA form as part of the loan negotiations or the lease negotiations, then try to sell the other party to the SNDA on that form as part of the second set of negotiations. If an agreed-upon form of SNDA already exists, it can take on a certain legitimacy and inevitability.

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[122] One might refer to both groups as "800-pound gorillas," except that they are the author's clients.

1. Timing of Execution: Lease First; SNDA Later

Often the landlord and the tenant will sign a lease, requiring the landlord to deliver an SNDA, signed by the lender, within a specified period or the tenant can terminate, offset rent, or exercise some other right. Counsel to the borrower or landlord should structure any such arrangement in a way that protects the landlord from the risk that the SNDA will never be delivered. For example, in one transaction the author handled for a lender, the landlord agreed (without the knowledge of the lender or its counsel) that the tenant could offset all its rent until the landlord delivered an SNDA, in this case from the ground lessor. The landlord never could deliver that SNDA, so the tenant could abate all its rent for the entire term of the lease. (The tenant ultimately chose not to exercise this remedy.)

Landlord's counsel will want to make sure that if the landlord cannot deliver an SNDA, then the tenant must "fish or cut bait" by some definite outside date. Typically, the author would expect a tenant to "fish"—keep the lease—rather than "cut bait" under these facts.[123] This alone may say something about how important SNDAs really are or are not.

2. Timing of Execution: Simultaneous Lease and SNDA

Often the tenant intends to begin incurring obligations and risks immediately in reliance on a newly negotiated lease. For example, the tenant may immediately exercise a termination option under its old lease or sign major contracts for tenant improvements and start work immediately. In these cases, a tenant that cares about an SNDA must insist on having it in place when the landlord and the tenant sign the lease. Otherwise, the tenant has simply not assembled the entire package it needs to protect itself and justify going forward.

As a practical matter, the tenant should be strategic about when and how to raise this requirement. If the tenant waits until negotiations are too far along, the tenant creates the practical risk that the SNDA will not be in place at the time of the lease signing. The tenant should put the issue on the table in its term sheet or other early communications about the leasing transaction.

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[123] For example, in *Principal Mut. Life Ins. Co.,* 77 Cal. Rptr. 2d at 484, the tenant asked for nondisturbance protections while negotiating the lease, but "he was told it was not negotiable; and . . . such a provision was not so important that he was unwilling to sign the lease without it."

3. Escrow

Sometimes the tenant will place signed lease documents in escrow, pending execution and delivery of an SNDA. This incurs the added time of setting up and potentially negotiating an escrow agreement or conditional delivery arrangement. It works for some transactions, though, and it produces certain theatrical benefits.

D. SNDAs for a Loan Closing

When a landlord or borrower refinances an already-tenanted property, the lender often will require the borrower to obtain SNDAs from some or all the commercial tenants in the building. The lender usually defines in the commitment letter how many SNDAs the borrower must deliver to close. For example, the lender might require SNDAs from the five largest tenants, plus enough additional SNDAs to cover a total of at least 75% of the rentable square footage of the property.

For a large project with strong, well-represented tenants, the borrower's task of obtaining all the SNDAs, dealing with tenant negotiations, and actually getting the SNDAs signed and delivered can be the critical path for the closing, and one of its most daunting and labor-intensive elements.

The parties can take some or all of the following steps (as well as other measures a suggested in this Article) to simply the process:

1. If an existing mortgagee and a tenant have already entered into an SNDA, the existing mortgagee can assign that SNDA to the new mortgagee, and the tenant's estoppel certificate can confirm the status of the SNDA and the tenant's recognition of the assignment.
2. If this lender has entered into other SNDAs with the same tenant at other location(s)—virtually always the case for major chain stores and major lenders—the parties can simply copy that previous SNDA.
3. In the commitment letter, the borrower can ask the lender to agree to accept (or at least not unreasonably disapprove) any form of SNDA required by any particular tenant's lease.

Even with measures such as these, somehow the timing almost always works out so that on the scheduled closing date the borrower has almost all the necessary SNDAs—with emphasis on the "almost"—and is one or two SNDAs short of the goal. This produces last-minute drama over whether the lender will close anyway or whether instead the borrower will live with a delay in the closing notwithstanding whatever compelling reason made it

essential for the transaction to close on a particular day.

As in the case of tenants that will almost always choose to keep a lease even without an SNDA rather than terminate the lease when the landlord cannot obtain the SNDA, the author's experience suggests that lenders will usually prefer to close loans as opposed to waiting just another day or two for a few more straggling SNDAs. Again, this may say something about the true practical importance of these documents.

E. Client Relations and Ethical Issues in SNDA Negotiations

As this Article amply demonstrates, any SNDA can raise a tangled mass of complicated little issues. Each can require thought, care, and analysis to resolve correctly. Failure to resolve one of these issues correctly can produce surprises and unexpected costs if and when a project gets into trouble. Many of these SNDA issues amount to genuine "business issues," although most of these "business issues" are of a minor, hypothetical, and convoluted nature.

Against that backdrop, the process of negotiating SNDAs raises its own set of client relations, ethical, and malpractice prevention issues. These include the following:

1. To the extent that an SNDA raises "business issues," does the client have the patience to deal with those issues? If not, should the attorney make decisions on those business issues? Each of these business issues could, under some confluence of circumstances, cost the client money or expose the client to risk. To what degree should the attorney involve the client in issues of this type even if the client has no patience for them?

2. When lender's counsel closes a major loan against a commercial property occupied by many well-represented tenants (for example a shopping center full of regional and national chain stores), many of these tenants will probably have extensive comments on any "standard lender's form" of SNDA.[124] Full negotiation of those comments may consume a great deal of legal time and attention. If dozens of SNDAs need to be heavily negotiated, that project can exceed in magnitude the job of negotiating all the borrower-lender loan documents.

[124] This assumes that either: (a) the tenants' leases do not define the form of SNDA each tenant must sign; or (b) the lender decides it cannot live with the forms of SNDA attached to the leases, and insists (optimistically) on using its own form of SNDA.

Will the transaction support the resulting legal fees? If not, should counsel simply throw up its hands and accept all remotely tolerable comments from all tenants? Whether to take that approach is ultimately a client's "business decision," but if the client does decide to do so, counsel will probably want to memorialize in writing somewhere the discussion that preceded that decision.

3. To the extent that the preceding comments suggest potential exposure for counsel, any such exposure should perhaps be discounted by its improbability of actually causing any damage. A large number of hypothetical circumstances must go wrong for any particular SNDA ever to become relevant and for any malpractice by counsel to cause any actual damage. This may be another way of arguing that SNDAs just do not matter that much, although that hardly seems a legitimate excuse for recklessness.

4. If any SNDA ever actually does become directly relevant, either a lender or a tenant will probably regret some of the language in the SNDA. If that regrettable language is "industry standard," then no one is likely to blame counsel, because "that's the way everyone does it." If, however, that language is unusual, creative, or "weird," then the adversely affected client may be more likely to blame its counsel for agreeing to it.

5. Assume lender's counsel is a large law firm, representing a wide range of clients in a wide range of industries. That client base will probably include at least some random subset of the major tenants in any commercial real estate project that contains a substantial number of regional or national tenants. Can counsel safely negotiate SNDAs against tenants that also happen to be clients of the same firm? Should counsel obtain a conflict waiver from both the lender and each and every tenant in the property that will negotiate an SNDA but the firm represents in some capacity? What if the law firm has confidential information about one of those tenants, such as the fact that it is about to file bankruptcy?[125]

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[125] These conflict issues are explored at length in Bruce Green & Joshua Stein,

6. To the extent that an SNDA requires any party to remember to do anything—such as give notices of default—counsel will want to think about how to assure that the client will remember to give those notices. Although any such failure to remember would probably not cause the client to blame its counsel, counsel will at least want to be able to show that it advised the client of what might need to be done.

7. Whenever a lease or a set of loan documents obligates a party to negotiate and deliver SNDAs in the future, whichever party assumes that obligation may want to ask to have the requesting party to agree to reimburse its attorneys' fees. In a set of loan documents, for example, the borrower's obligation to reimburse the lender's attorneys' fees should extend to the lender's attorneys' fees in negotiating SNDAs, both for the closing and thereafter. In a lease, the landlord would like the tenant to agree to reimburse the landlord's attorneys' fees for future SNDAs. The tenant may make exactly the opposite suggestion. It is an issue that counsel to any of these parties may wish to raise in any loan or lease negotiations.

Whenever any commercial real estate attorney toils in the SNDA fields, that attorney should keep in mind these and other ethical and client-relations questions, any of which can arise at any time. Because SNDA negotiations are rarely "front and center" in the loan documentation process, but at the same time they are full of complicated little issues in which one side will "win" and the other side will "lose," SNDAs may be particularly likely to produce unexpected problems of these types.

F. Loan Documents—Leasing Criteria

To facilitate its future leasing activities, the landlord (borrower) will want the lender to agree in advance (in the loan documents) to deliver

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Adventures in the Mortgage Trade: A Case Study in Legal Ethics in Commercial Real Estate Finance, 470 PRACTISING L. INST.: COM. REAL EST. FIN. 885 (2001). In that case study, a lender financed a whole portfolio of buildings, all occupied by a single manfuacturing company. When the financing for many but not all of the parcels had already closed, the attorney handling the loan transaction learned, through an all-attorneys email, that the tenant company had already engaged the lender's law firm to assist the tenant in filing for bankruptcy. Whatever the general ethical rule may be for handling conflicts in routine SNDA negotiations, the facts of this hypothetical case surely cried out for running a conflict search on the single major tenant and not merely on the borrower.

SNDAs to future tenants. The lender should establish protective criteria to assure that the lender will be willing to live with any nondisturbed lease, such as minimum rent level, maximum term, arm's-length nature, and restrictions on other terms and conditions.[126] Because a preapproval right for certain leases should give the lender comfort about those leases, the landlord (borrower) should at least persuade the lender to agree to enter into an SNDA with any future tenant under any lease that the lender has approved.[127]

Along similar lines, if the landlord negotiates in the loan documents the right to amend leases within certain agreed limitations, the landlord must consider how that flexibility interacts with the restrictions in an SNDA. If the SNDA prevents landlord and tenant from entering into any lease amendment at all without the lender's consent, then the landlord may lose in the SNDA the flexibility that it negotiated in the loan documents.

To prevent that problem, the landlord may want the SNDA to define and allow certain lease amendments that do not require the lender's consent. That definition should, however, be as specific as possible. If the loan documents allow the landlord to enter into any lease amendment that is "commercially reasonable and made in good faith," the recitation of that same language in the SNDA might not help much, because the tenant may want the mortgagee to confirm "commercial reasonableness" for every lease amendment. Instead, the test for a permitted amendment should be as objective and easy to apply as possible.

For example, the loan documents and the SNDA might define a permitted lease amendment as one that does not decrease the rent, extend the term (other than an extension priced within 5% of market value as evidenced by a letter from a specified commercial real estate brokerage firm), or materially increase the landlord's obligations.

H. Loan Documents—Form of SNDA

When a lender agrees to deliver SNDAs for future tenants, the next

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[126] The landlord (borrower) should be wary of the lender's conditioning its agreement on the future lease being on the landlord's standard (lender preapproved) lease form without material changes. Any tenant with the leverage to obtain (and insist upon receiving) an SNDA also typically has the leverage to change the standard lease provisions.

[127] It would seem uncontroversial that any lease actually reviewed and approved by a lender should be one that the lender is willing to live with and thus nondisturb. In practice, though, lenders sometimes hesitate to do so. In a perfect world, they would prefer to defer any decision about the desirability of any particular lease until the foreclosure process begins.

question will be: What form of SNDA will the lender use? The lender's standard form of SNDA as in effect from time to time is unlikely to satisfy major chain store tenants. That form of SNDA will need to be negotiated every time. But a lender will hesitate to include a prenegotiated form of SNDA because of concern that tenants will beat up on the lender from there.

I. Getting It Signed and Done

Once a lender and a tenant have negotiated out the form of an SNDA, they must sign it. Usually the tenant signs first, then the lender. With amazing frequency, the lender never signs it, perhaps thinking that this gives the lender all the benefits of the SNDA with none of the burdens. That thought is probably misguided. Another explanation may be that once the parties sign the SNDA, the closing has already occurred and therefore, it is a postclosing activity, and no one pays much attention to it.[128]

Regardless of the cause, SNDAs signed by the tenant often seem to fall into a hole somewhere in the lender's organization. In response to that problem, tenants increasingly insist that the lender sign the SNDA within a certain finite period, after which it automatically becomes ineffective. The tenant's leverage depends, of course, on the terms of the tenant's lease. If a tenant attaches a "fuse" to its signed SNDA, the tenant can be reasonably sure that the landlord and lender will get it signed and returned quickly. In that case, both landlord and lender will want to confirm that they can establish a written record of returning the signed SNDA to the tenant.

J. Evaluating Whether To Record

Lenders and tenants should both consider recording SNDAs. At least one commentator has suggested that if the tenant has perfected a prior interest in the property, such as by recording a lease or taking possession, a lender should generally record the SNDA.[129] The same commentator suggests that recording an SNDA may increase the likelihood that a court will honor it.[130] Although the author questions that proposition, one of the great advantages of recording an SNDA is the fact that, as a practical matter, the parties will never forget about it in connection with a future refinancing; it will turn up on every title report. Furthermore, the SNDA will never get lost.

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[128] *See* JOSHUA STEIN, A PRACTICAL GUIDE TO REAL ESTATE PRACTICE 235-38 (2001).
[129] *See* Homburger, *supra* note 13, at 425.
[130] *See* Homburger, *supra* note 13, at 426.

K. The SNDA Tapes

Regardless of the context in which a lender, landlord, and tenant negotiate an SNDA, certain arguments arise again and again in those discussions. One might call these arguments the "SNDA Tapes" because they are effectively tapes that get replayed every time SNDA negotiations occur. Some of them get replayed just as often in other negotiations, too.

Many of the SNDA Tapes have a certain ring of fairness and rationality to them. Ultimately, though, the outcome of any SNDA negotiation usually depends less on fairness and rationality than on the negotiating leverage of each party and the overall context of the discussions.

Exhibit B collects all the SNDA Tapes, listing all the usual arguments that the parties to any SNDA make in negotiations.

XI. ALTERNATIVES TO SNDAS

If SNDAs cause delay, excessive negotiations, and other trouble in the closing process, can the parties use some other technique to mitigate the risks that an SNDA is intended to mitigate? Can a lender institute other measures to protect itself from those risks? The following discussion examines some possible alternatives to an SNDA and considers the feasibility and potential value of each alternative. Later, Section XII(B) of this Article proposes one last solution to the problem.

A. Conspiracy Prevention: Alternatives to SNDAs

1. Section 291-f Notices

Even without an SNDA, lenders in New York can address all the Landlord-Tenant Conspiracy issues by sending notices under New York Real Property Law section 291-f, at least for leases that qualify for this procedure.[131]

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[131] *See* N.Y. REAL PROP. LAW § 291-f (McKinney 2002), which provides in part as follows:

> An agreement, referring to this section, contained in a recorded mortgage of real property, or in a recorded instrument relating to such mortgage, restricting the right or power, as against the holder of the mortgage without his consent, of the owner of the mortgaged real property to cancel, abridge or otherwise modify tenancies, subtenancies, leases or subleases of the mortgaged real property in existence at the time of the agreement, or to accept prepayments of instalments [sic] of rent to become due thereunder, shall become binding on a tenant or subtenant after written notice of such agreement, accompanied by a copy of the text thereof. . . .
>
> The very existence of this statute may imply that under New York common law a

2. Effect of Section 291-f Notice

Under section 291-f, a lender can notify a commercial tenant (with an unexpired lease term of at least five years) of the existence of the lender's mortgage and the restrictions in the mortgage on Landlord-Tenant Conspiracies. After the lender gives that notice, any Landlord-Tenant Conspiracy is void against the lender.

For leases that exist when the mortgage, or assignment of rents, is recorded, a lender can use section 291-f as a full substitute for an SNDA, at least to protect the lender from Landlord-Tenant Conspiracies entered into after the lender has recorded its mortgage and given the section 291-f notice.[132]

Section 291-f does not address leases entered into after the mortgage. Presumably, future tenants would be both totally subordinate to the lien of the mortgage and automatically on notice of and bound by the restrictions in the mortgage. This occurs by operation of the recording system, the same way an existing tenant who receives notice under section 291-f is bound.[133]

If a lender still has any concern about whether the mere recording of a mortgage or assignment of leases restricting Landlord-Tenant Conspiracies will bind tenants under future leases (and give the lender the same protection as section 291-f for existing leases), a lender has several more arrows in its quiver. The lender can have the borrower execute a separate, confirmatory assignment of a significant future lease after the new lease becomes effective (or possibly commences), then record the confirmatory assignment, and finally, send a section 291-f notice to the tenant under the new lease.

In addition, for new leases, a lender can require that the lease, as well as the landlord's approved standard form for the building, contain the tenant's acknowledgment that the lease is being assigned to the lender and that the mortgage restricts Landlord-Tenant Conspiracies. This could eliminate any need for the lender to rely on unilateral, actual, or construc-

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tenant under an existing lease does not have constructive notice of a subsequently recorded mortgage. This statute requires the lender to give the tenant actual notice before the tenant is bound by mortgage restrictions on Landlord-Tenant Conspiracies. *See id.* Circumstances such as these help explain why mortgagees do not want to rely on the recording system for these issues, at least for amendments or modifications to leases that predated the mortgage.

[132] Because New York is not an automatic-cutoff state, certain other protections afforded by an SNDA become less significant.

[133] For more discussion on subordination generally, see *supra* pp. 720-732.

tive notice.

Finally, for a significant new lease, the lender can require an estoppel certificate from the tenant. As a practical matter, if the lease is significant to the lender, it is probably significant to the tenant also. The tenant will therefore demand an SNDA as a condition to entering into the lease. This brings us back full circle to the desire for an SNDA and its usefulness in helping the lender protect itself against Landlord-Tenant Conspiracies (among other things).

3. Remaining Issues Under Section 291-f.

A lender trying to comply with section 291-f must note the following concepts:

(a) Recorded Agreement. A section 291-f notice must include "a copy of the text" of the recorded agreement restricting Landlord-Tenant Conspiracies. (Will a copy of the unrecorded agreement suffice?)
(b) Statutory Reference. The restrictions in the recorded mortgage (or related agreement) must expressly refer to section 291-f. So if the recorded document does not mention section 291-f, the lender cannot rely on it. This requirement is a great example of a "trap for the unwary." It also means, though, that the loan documents will remind a strong borrower that it may want to demand that the lender agree not to exercise its rights under section 291-f.
(c) Lease Criteria. The lease must be a commercial lease with an unexpired term of at least five years.
(d) Strict Construction. Section 291-f has been strictly construed to apply only to matters it directly covers.[134]

4. Borrower Sensitivities

Borrowers sometimes object to a lender's use of section 291-f, based on a professed concern that it may hurt landlord-tenant relations. Borrowers sometimes say that tenants who receive a section 291-f notice may think that the borrower or landlord is in trouble. Because of these sensitivities, lenders may decide not to send these notices at the outset.[135] Lenders may,

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[134] *See E. N.Y. Sav. Bank,* 608 N.Y.S.2d at 977 (citing *Poughkeepsie Sav. Bank*, 84 A.D.2d at 214).

[135] Whether to do so depends partly on the particular lender's appetite for risk and its view of the particular borrower. Many, but by no means all, New York lenders choose to

however, be able to respond to the borrowers' concerns by careful wording of the section 291-f notice. Lenders can craft the notice to look more like a business letter than a document relating to an imminent loan default.

Conversely, if the borrower truly does not want these notices sent at all, the borrower should raise the issue in the loan negotiations.

5. Section 291-f Equivalent Outside New York

Even if states outside New York do not have a statutory equivalent to section 291-f, a lender may be able to fashion a home-made self-help version of section 291-f. The lender unilaterally may achieve the same result as section 291-f by sending a formal notice to any tenant. The notice should place the tenant on notice of (1) the mortgage; (2) the assignment of the lease; (3) the lender's existence and interest in the lease; and (4) the restrictions on Landlord-Tenant Conspiracies in the recorded mortgage (the restrictions should expressly state that any Landlord-Tenant Conspiracy will not bind the lender). The lender may wish to have the landlord or borrower join in any such notice.

In the face of such a notice, an innocent tenant may be less likely to participate in what would otherwise constitute a Landlord-Tenant Conspiracy, and a court may be less likely to tolerate it.[136] All this sounds fair and equitable. It might even work.

B. Alternative: Estoppel Certificates

If a lender (1) cares only about Landlord-Tenant Conspiracies, and (2) does not care much about pure priority ("subordination") or Lender-Tenant Risk Shifting, then all the protections that a lender obtains from a typical SNDA can be condensed into a few short and relatively uncontroversial paragraphs added to a standard tenant estoppel certificate. These paragraphs should track the lease language suggested in Exhibit A, and add an acknowledgment of the existence of a particular lender at the time of signing. This approach eliminates the need for SNDAs completely. A well-represented tenant would ask the lender to countersign the document or in some other way confirm the nondisturbance elements.

Although lenders sometimes can use estoppel certificates as a simpler substitute for an SNDA, this shortcut may leave behind a mess, as follows.

1. Does the estoppel certificate modify the lease? Can it?

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send section 291-f notices. Even lenders that choose not to send the notices should insist on including section 291-f language in their mortgages.

[136] *See* the discussion of Landlord-Tenant Conspiracies, *supra* pp. 712-715.

2. If the tenant assigns the lease, will the estoppel certificate bind the assignee?
3. Should the estoppel certificate be recorded?
4. Can the lender's assignee also rely on the estoppel certificate? (Probably yes, if the estoppel certificate says so.)
5. Will anyone think of looking in the estoppel certificate when looking for an SNDA?
6. When the parties later amend the lease, will they remember to list the estoppel certificate as one of the documents that constitute the lease? If not, the future lease amendment (or even some future estoppel certificate) may ratify the lender-protection estoppel certificate out of existence.

Issues such as these may lead a lender to prefer a straightforward SNDA (or formal lease amendment) to an estoppel certificate.

C. Alternative: Personal Liability

If a borrower has no intention of ever engaging in Landlord-Tenant Conspiracies, then the individual principals of the borrower can use nonrecourse carveouts as a way to eliminate the whole issue.

The principals of the borrower can (1) guaranty to the lender that no Landlord-Tenant Conspiracy will ever occur; and (2) indemnify the lender against any loss the lender may suffer if any Landlord-Tenant Conspiracy does occur. To the principals, a personal guaranty of this type may be tolerable, as Landlord-Tenant Conspiracies are (one assumes) entirely within their control.[137] By promising not to do something they never intended to do, and backing that promise with their personal credit,[138] they can eliminate or at least reduce the lender's risk of not obtaining SNDAs from tenants. In some cases, stepping up to guaranties of this type may be necessary to close a deal. These personal guaranties let the borrower entirely avoid the pain and agony of SNDA negotiations. They may also constitute a reasonable mechanism to protect a lender from the risk of a lost or stolen security deposit, whether it is characterized as a Landlord-Tenant Conspiracy or as Lender-Tenant Risk Shifting.

But what about the other issues that underlie Lender-Tenant Risk

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[137] *See generally Principal Mut. Life Ins.*, 77 Cal. Rptr. 2d at 479.

[138] Although personal guaranties of this type should give a lender a great deal of comfort on these issues, they are somewhat inconsistent with the theory of nonrecourse lending. They force a lender to consider credit issues outside the real estate. This may create issues for future purchasers of the loan, or if the lender wants to securitize it.

Shifting? Can a borrower logically offer a personal guaranty as a mechanism to protect a Successor Landlord from claims made by tenants relating to preforeclosure landlord defaults? Not necessarily.

For a nonrecourse loan, a personal guaranty is probably inappropriate as an SNDA substitute for solving the issues that underlie most Lender-Tenant Risk Shifting. A personal guaranty of this type would violate the fundamental premise of nonrecourse lending by effectively obligating the borrower's principals to "dip into pocket" to correct problems with a particular real estate investment. If curing a landlord default required spending money, the principals would be forced to invest additional money in the project because they had signed a personal guaranty to protect the Successor Landlord against claims arising from the landlord's defaults.

In contrast, the general premise of nonrecourse lending is that so long as the borrower's principals do not wrongfully take money out of the project, they have no duty to put more money into it. Consequently, the principals' guaranty that the borrower will not default on leases may be problematic. On the other hand, a lender may argue that although nonrecourse lending gives the borrower the right to walk away at any time, as long as the borrower has not yet exercised that right, the lender can reasonably require the borrower and its principals to invest whatever additional capital their asset requires.

D. Some Other SNDA Substitutes

Depending on the circumstances, borrowers and lenders may also use a few other mechanisms as substitutes for an SNDA. If the lender fears responsibility for a lost or stolen security deposit, the lender can insist on holding the security deposits itself, at least when they exceed a certain level. If the lender fears personal liability under the lease if the lender ever becomes a Successor Landlord and the lease does not exculpate the landlord, the lender can solve the problem by creating a single-purpose shell entity to bid at the lender's foreclosure sale.[139] If the lender fears the borrower will misapply or accelerate collection of rent, the lender can create a lockbox mechanism to collect rent, and require the tenants to pay all rent into the lockbox from the moment of closing.

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[139] *See Vallely Invs.,* 106 Cal. Rptr. 2d at 695. Here, the lender held a deed of trust on a ground lease and had a creditworthy affiliate bid at the trustee's sale. That affiliate assumed the ground lease as part of the closing pursuant to the trustee's sale. It ultimately learned to its chagrin that disposing of the ground lease did not dispose of its liability as tenant under the ground lease. *See id.* at 694. The lender might not have had the problem if it had sent a shell entity to bid at the sale.

XII. BOTTOM LINE ON SNDAS

The preceding discussion fully demonstrates that lenders worry about leases and use SNDAs to try to mitigate some of those concerns. It also shows, though, that some of the worrying may be unnecessary or at least overstated, and that the role of SNDAs in commercial real estate transactions has become rather disproportionate to whatever problems they solve. Moreover, to the extent that the problems really exist, lenders can often solve them as effectively through a number of other devices, some much simpler than an SNDA. This section seeks to summarize the author's conclusions and views regarding SNDAs, followed by a suggestion for a much simpler approach to the issues that drive an SNDA.

A. Summary of Conclusions

Based on the preceding discussion and the author's understanding of commercial practices regarding SNDAs, the following conclusions about SNDAs may be fairly drawn:

1. *Lenders Don't Really Need Subordination*. Pure subordination of bona fide arm's-length leases that the lender has approved is of no great importance to anyone, notwithstanding the Regulatory Myth. Lenders do not really need to terminate these leases after foreclosure. In practice, they rarely, if ever, are likely to do so or even try to do so.[140]
2. *Providing Comfort on Attornment.* Although occasional questions arise regarding the possible need for attornment agreements after foreclosure, whatever uncertainty exists probably can be dealt with through appropriate language in leases or estoppel certificates.
3. *Landlord-Tenant Conspiracies*. Lenders fear Landlord-Tenant Conspiracies, but the courts generally seem to do a decent job of protecting lenders from the problem, often by applying traditional rules regarding priority of competing interests in real estate.
4. *Acceptance of Risk-Shifting*. Although Lender-Tenant Risk

[140] The one area where subordination might matter is in the resolution of conflicts between mortgage and lease regarding application of casualty and condemnation proceeds. The lender could simply try to persuade the tenant to agree to a simple statement (in the lease or in an amendment or estoppel certificate) that the mortgage governs in the event of such a conflict. Whether a tenant would accept that proposition is another matter.

Shifting may lack logical justification, it is accepted at least to a degree in the world of commercial real estate. For the most part it, must be done contractually because the courts will not impose it.

5. *Nonacceptance of Lease Improvement*. Most tenants object to lenders' efforts to achieve any Post-Foreclosure Lease Improvement, and those objections usually win the day.

B. A Better Way?

In place of SNDAs and all the trouble, issues, and negotiations they cause, the author submits that lenders, landlords, and tenants should consider handling the lender-tenant relationship in a way that reflects the true business realities and expectations of that relationship, without being sidetracked by spurious concerns such as subordination.

As a first step, lenders should seriously consider subordinating their mortgages to all leases that: (1) are entered into at arm's length; and (2) otherwise comply with the loan documents. Lenders may also want to institute other quality control measures, such as use of a standard form or having some form of lender review and approval. Even in the case of such a subordination, though, if lenders can do so, they may want to persuade tenants to agree that any inconsistency on casualty or condemnation proceeds will be resolved in favor of the mortgage.

Subordination of a mortgage to a lease removes the tenant's concern about possibly being wiped out in a foreclosure, and eliminates the lender's concern about automatic cut-off states and the possible need for nondisturbance and attornment arrangements. It would deprive the lender of the benefits of its lien being prior to leases, but those benefits are purely hypothetical and of no real practical value, except perhaps as they relate to the treatment of loss proceeds, a much narrower issue that can be dealt with in a much narrower way.

This measure might be considered radical, although as previously noted in this Article at least one major insurance company for years has followed a similar practice routinely with no apparent adverse results.[141]

As a compromise measure, to prevent issues regarding the priority structure and to preserve flexibility, leases expressly might give mortgagees the right to subordinate their mortgages, in whole or in part. Leases should state that if a lender has actually subordinated to a particular lease, then no further lender-te

[141] *See supra* note 57 for a description of the policies of TIAA-CREF in this area.

nant documentation is necessary.

Whether a lease is prior or subordinate to a mortgage, the lease itself should build in a reasonable set of lender protections, covering the major bases of an SNDA, thus eliminating the need for any separate SNDA. A reasonable set of lender protections might cover the following:

1. *Landlord-Tenant Conspiracies*. Lenders are entitled to protection from Landlord-Tenant Conspiracies. Tenants should have no problem agreeing to that protection. Although case law demonstrates that courts will often protect lenders from Landlord-Tenant Conspiracies (at least egregious ones) even if no document at all gives the lender this protection, lenders understandably do not want to rely on that result. Therefore, leases should build in some measure of Landlord-Tenant Conspiracy Prevention measures.
2. *Lender-Tenant Risk Shifting*. For Lender-Tenant Risk Shifting issues, leases should build in a reasonable middle ground outcome—for example, a requirement for the tenant to give the lender notice of any problem or issue with the landlord. After foreclosure, the Successor Landlord would be subject only to any claims or offsets that arose after the date of such notice.
3. *Post-Foreclosure Lease Improvement*. For Post-Foreclosure Lease Improvement, the lender should either approve the lease (and the borrower's standard lease form) or reject it, and make sure that the terms of any approved lease are satisfactory. It is unreasonable for a lender to use an SNDA to try in any significant way to improve the terms of a lease after foreclosure.
4. *Lease Continuation*. The lender protection language in a lease should confirm (simply for comfort) that the lease will survive any foreclosure or similar event, so the tenant cannot assert creative theories for termination of the lease at that point.
5. *Activation of Protections.* By their terms, the lender protections suggested above would become effective, for the benefit of any particular lender (and its successors and assigns), as soon as the tenant received notice of a mortgage or signed an estoppel certificate directed to a particular lender.

Exhibit A to this Article sets forth a few paragraphs that a landlord might include in its standard form of lease to cover all these issues. The basic language proposed in Exhibit A does not address subordination because under the structure proposed here, approved leases would be prior

to mortgages and that would be the end of it. (As a variation, a lease could say: (1) this lease is subordinate to mortgages provided that the mortgagee has agreed to nondisturbance protections; and (2) any lender has the option to make its mortgage subordinate to that lease.) Exhibit A also offers some optional language along these lines.

To implement these arrangements for any particular closing and to eliminate residual issues and uncertainties, for any particular transaction the lender should consider adding a few specific provisions to the form of estoppel certificate for tenants to sign.[142] Specifically, the estoppel certificate should include the tenant's acknowledgment that the tenant knows about the loan and the lender, and that particular lender and its successors and assigns are entitled to the protections described above and in the lease.

A lender may choose to supplement these documents with a personal guaranty from the borrower's principals against at least Landlord-Tenant Conspiracies and misuse of security deposits, to provide further comfort that the borrower will not leave behind a mess after foreclosure.

Even without a personal guaranty, the structure just proposed would produce a result that is fairly consistent with negotiated outcomes in well-documented transactions, but without the need for lenders or tenants to negotiate SNDAs. This structure would simplify loan closings and lease negotiations, while giving both tenants and lenders the protections they legitimately need.[143]

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[142] As is always true, the lease should obligate the tenant to sign estoppel certificates promptly upon request. The landlord should attach the form of estoppel certificate to the lease as an exhibit, but reserve the right to require an estoppel certificate that goes beyond the attached form, if, for example, a particular lender requires it.

[143] A securitized lender would also need to consider whether the specific arrangements in a particular case would satisfy the requirements of the rating agencies.

EXHIBIT A
LENDER PROTECTION LANGUAGE FOR A LEASE

Any lease could include the following language to implement the arrangements proposed in this Article, both for the benefit of a mortgagee and for the benefit of a possible ground lessor. Capitalized terms would require appropriate definitions. With variations, language such as this could appear in an estoppel certificate. For the reasons described in Section XI(B) of the foregoing Article, though, an estoppel certificate is not as good as the Lease itself.

Landlord and Tenant agree as follows, which agreement is also intended to benefit, and be enforceable by, every present and future Superior Estate Holder[144] and Successor Landlord, provided in each case that Tenant has received notice of such Superior Estate Holder or Successor Landlord.[145]

Nonconsensual Transfer. This Lease shall not terminate upon any foreclosure or similar transfer affecting the Building, conveyance of the Building pursuant to a transfer in lieu of foreclosure, sale or other transfer of the Building through a Landlord Bankruptcy, eviction of Landlord under a Ground Lease, or any other termination of a Ground Lease (any of the foregoing, a "*Nonconsensual Transfer*"). If a Nonconsensual Transfer occurs, then this Lease shall continue as a direct lease between Tenant and the successor to Landlord's estate under the Nonconsensual Transfer (the "*Successor Landlord*"). A Successor Landlord would include any: foreclosure sale purchaser and, after termination of any Ground Lease, the ground or underlying lessor.

Amendments, Terminations, Etc. Successor Landlord shall not be bound by any amendment, cancellation, surrender, or termination (including one resulting from a rejection of this Lease in any Bankruptcy Proceeding) of this Lease, or any waiver of any terms of this Lease, made (in any of the foregoing cases) without Superior Estate Holder's prior written consent, except a unilateral termination by Tenant under the express terms of this Lease.[146] Before exercising any right to terminate this Lease by reason of

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[144] "Superior Estate Holder" means mortgagee, deed of trust beneficiary, or landlord under any ground lease.

[145] The agreement must also bind any future Landlord, achievable through standard "successors and assigns" language in the Lease.

[146] If the loan documents let the borrower/landlord enter into certain lease amendments without the lender's consent, this language will need to reflect that flexibility. *See supra* Section X(F).

Landlord's default, Tenant shall give Superior Estate Holder notice of such default and a reasonable opportunity to cure it.

Certain Claims, Etc. Except as this Lease otherwise expressly provides, Successor Landlord shall not be: (1) subject to any abatement, claim, counterclaim, credit, deduction, or setoff against Tenant's obligations under this Lease (a "*Claim*") arising from acts or omissions of the prior Landlord (except to the extent of an offset for any actual direct damages that both: (a) this Lease would allow Tenant to assert against Landlord; and (b) accrue after Tenant has given Lender notice of such Claim); (2) obligated to pay or reimburse Tenant for any sum for which the Lease required the prior Landlord to pay or reimburse Tenant; or (3) bound by any payment of Rent that Tenant made more than 30 days before the date when this Lease required such payment (unless paid into a lockbox maintained for Superior Estate Holder).

Certain Surviving Claims. Notwithstanding anything to the contrary in the preceding section, any Successor Landlord shall be subject to, and bound by, all of Tenant's rights under this Lease regarding: (1) any security deposit, whether or not Successor Landlord received it; (2) construction of, and/or contribution to Tenant's cost of constructing, Tenant's Initial Alterations; and (3) any right of offset or abatement expressly provided for in this Lease, but only to the extent that such offset or abatement rights accrued after Tenant gave Superior Estate Holder timely notice of the circumstances that led to such right of abatement or offset.[147]

Loss Proceeds. In the event of any inconsistency between Tenant's and a Superior Estate Holder's rights regarding any Loss Proceeds, such inconsistency shall be resolved in favor of the Superior Estate Holder.[148]

Payment of Rent. If any Superior Estate Holder directs Tenant in writing to do so, Tenant shall pay (and Landlord directs Tenant to pay) all Rent in accordance with the directions of such Superior Estate Holder and not to Landlord, unless and until such Superior Estate Holder notifies Tenant in writing to the contrary.

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[147] This paragraph reflects certain concessions that any moderately strong tenant would usually request and obtain.

[148] This paragraph deals with the one area where "subordination" really matters, but without requiring "subordination" more generally. Any tenant that cares about Loss Proceeds and has enough leverage to obtain favorable language in its Lease will probably have no interest in giving up that favorable language for the benefit of a Superior Estate Holder.

NOTE: The following provisions would not be appropriate for the structure proposed in this Article, but may be helpful in cases where a lender prefers some variation on that approach.

Subordination. This Lease and all rights and claims of Tenant in and to the Premises are subject and subordinate to all right, title, and interest of every Superior Estate Holder, except as this Lease otherwise expressly provides and as follows. Any Superior Estate Holder may elect in writing at any time that all (or any part, as Superior Estate Holder designates)[149] of the right, title, and interest of such Superior Estate Holder shall be subordinate to this Lease and Tenant's rights and claims under this Lease (a "*Subordination Election*"). Any Subordination Election shall become effective when a copy or original of it is either delivered to Tenant or recorded. Such Superior Estate Holder's right, title, and interest in the Premises shall then become subordinate to the Lease, whether the Lease is dated before or after the date of such Superior Estate Holder's interest in the Premises, to the extent set forth in the Subordination Election.[150]

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[149] The Superior Estate Holder would probably want to remain "prior" as to issues regarding loss proceeds.

[150] Superior Estate Holder might also want the right at any time unilaterally to retract or rescind any Subordination Election. Although more flexibility is always better, any such right of retraction seems unnecessary and may create new issues. If a Superior Estate Holder obtains such a right, the Lease would then go on to state that after the exercise of such right, the relative priorities of the Lease and the interest of such Superior Estate Holder shall then be restored as they were immediately before the Subordination Election.

EXHIBIT B
THE SNDA TAPES

This Exhibit collects all the arguments that landlords, lenders, and tenants typically make in any negotiation of an SNDA. The arguments are numbered for convenient use in actual negotiations. Variations and alternatives are bracketed. With slight changes, some of these arguments work just as well—and arise just as often—in almost any other negotiation.

A. Tenant's Arguments

1. "I've already finished negotiating my lease. Why should I give my landlord's lender anything more than I agreed to give my landlord?"

2. "The rent I agreed to pay is supposed to give me a package of rights and benefits including offset rights, payment of build-out costs, expansion options, off-premises restrictions, factual assurances, and so on. Why should I agree to give up part of that package without getting something for it?"

3. "My relationship is with my landlord. I don't want to have to remember to deal with a lender."

4. "I'm not a cop. I don't want to have to police my landlord. If you don't trust your borrower, don't lend to them."

5. "We would never do any of these bad things."

6. "I don't want to be stuck in a dispute between my landlord and its lender."

7. "I need a place to operate my business. I can't wait around while the lender tries to cure the landlord's default."

8. "You chose your borrower. I didn't."

9. "My leasing of this project benefits both the landlord and the lender by making the project possible. Everyone has to give a little to help make that leasing possible. We're all in this boat together."

10. "I need flexibility. I don't know what the future holds. I don't want to be boxed in."

B. Lender's Arguments

1. "My financing of this project benefits both the landlord and the tenant by making the project possible. Everyone has to give a little to help make that financing possible. We're all in this boat together."

2. "Our underwriting of this loan assumes a long-term uninterrupted rental stream from this lease. We need to minimize the risk that anything

will interrupt that rental stream or else lend less money on this project."[151]

3. "I'm not in the business of owning and operating real estate."

4. "I need to be able to sell this property at a foreclosure sale, and I don't want to discourage bidders."

5. "I don't want to be stuck in a dispute between my borrower and its tenant."

6. "The servicer won't be able to do it."

7. "After foreclosure, we don't want to be stuck cleaning up someone else's mess."

8. "The [rating agencies] [B-piece buyers] [syndicate members] won't let me."

9. "If I ever take over the property, I will have just lost a lot of money on this loan. How can you possibly expect me to agree to pour more money into this asset?"

10. "I need to have a clean slate when I take over."

11. "After foreclosure, we probably won't even have access to the books and records for any claims the tenant might have against us. So how can we possibly agree to be responsible for those claims?"

12. "I understand you need flexibility. But aren't you really saying you want enough flexibility so you can be a crook?"

13. "I can't take responsibility for a landlord's mismanagement. I can't control the landlord."

14. "I won't be able to sell the loan."

C. Landlord's Arguments

1. "I've really gone to bat for you, and this is the best I'm going to be able to get."

2. "Do you really think this is such a large risk?"

3. "We'd never do these bad things. Why are you so worried about them?"

4. "You have to sign it."

5. "You're not being reasonable, and I'm going to sue you for losing my deal."

6. "The loan documents prohibit us from doing these things. If we did any of them, it would be a default. Why do you need to bother the tenant?"

7. "They are very unreasonable. Their counsel is very fierce and tough. I think their counsel actually has fangs and eats raw meat for breakfast. You're very lucky to get as much as you did. Be glad that you got it."

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[151] The reference to "or else" will usually catch the borrower's attention.

8. "I need [the money] [the tenant]."

9. "We never sign personal guaranties of anything."

10. "We'd be happy to cover this issue with personal guaranties, but our ownership is structured in a way that it's just not feasible for anyone to sign a personal guaranty."

D. Everyone's Arguments

1. "We should handle this the same way everyone else does."

2. "It's just standard boilerplate."

3. "I think I saw an article somewhere that said that your side doesn't win these arguments."

4. "The [_____ committee] [my lawyer] won't let me."

5. "It's against our policy."

6. "We'll never remember."

7. "We grant only our standard form of nondisturbance agreement."

8. "Don't you trust us to do the right thing? Do you really think we won't act reasonably and in good faith?"

9. "Of course I trust you, but you might have a change in management."

10. "If I were dealing with _____, I wouldn't have to undergo this brain damage."

11. "It's such a small risk. Why are you so worried about bearing it?"

12. "[What you're asking for is not] [All I'm asking for is] market standard on this issue."

13. "We don't have a budget to pay for the risk you're asking us to bear."

14. "Given how much turnover we have here, we can't possibly agree to anything in an SNDA that would require us to remember to do anything."

15. "I don't want to have to read a bunch of documents to which I'm not a party to decide whether anything in them is inconsistent with some documents to which I am a party."

16. "I can't assume an open-ended undefined risk that I can't control."

17. "I need to achieve consistency across my portfolio; otherwise, whoever is administering this transaction will probably make a mistake if a problem ever arises."

18. "The concession you are requesting would require Board approval, and the Board doesn't meet until the day after the day you want to close."

19. "The only person who can approve what you're asking for is on vacation."

20. "I realize no court would ever allow this problem to happen. But

I don't want to have to litigate it. I don't want to have to rely on the courts."

21. "We don't negotiate these documents."
22. "If we did it for you, we'd have to do it for everyone."
23. "How do the lawyers think of all these things?"
24. "Does any of this stuff really happen?"