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Protection for Commercial Tenants when Landlord is in Financial Difficulty

Take Another Look at Your Lease and Related Documents. You've carefully negotiated your lease, perhaps did it years ago. Your landlord seems to be treating you well and things seem to be going fine as you grow and manage your business. However, there's a potential threat looming for your business that you may not be aware of.

Overleveraged Commercial Properties Heighten Tenants' Need for SNDAs

- Will your lease protect you in the event that your landlord experiences financial difficulties and can't pay its mortgage?
- Do you know what your legal options are if you get notice that your building is suddenly owned by someone else, someone you have never met nor dealt with before?
- Do you know what to ask regarding your lease's protections?
- What provisions can you put in your lease so you are protected in the event of an economic reversal of fortune for your landlord?
- Do you know what protections a Subordination and Non-Disturbance Agreement (SNDA) provides?

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Commercial Property Values and Impact on Business Owners

The last economic boom was fueled by "easy" credit, and the current recession has set the stage for a "perfect storm" where a major cross section of commercial real estate properties (office, retail, warehouse, hospitality, etc.) are overleveraged and in imminent danger of foreclosure by mortgage lenders.

Commercial space vacancies are up in most markets what with "right-sizing" by companies (reduction in space by office users) and bankruptcies of major retailers. As a consequence, many commercial properties have had 35% and greater deterioration in their values (as against former highs when financing occurred during 2006-2008 cycles; values of commercial properties are largely determined by their expected cash flow).

These diminished market values will not support the refinancing of many commercial mortgage notes set to mature in the next three years. Quite a lot of properties are currently financed by five year notes. Adding to the overall pain is the anticipated increase generally in non-performing commercial mortgage loans, and foreclosures resulting from the failure of cash flows necessary to cover ongoing debt service.

Landlords across the spectrum, from individual owners through to major REITS, will simply not be able to find the equity necessary to be able to refinance their mortgages in light of diminished market valuations and lenders' more stringent loan-to-value (LTV) requirements. Many commercial properties will thus revert to ownership by foreclosing mortgage lenders. Those lenders (as new, unwilling owners of the properties) will seek all alternatives at their disposal to maximize recoveries when liquidating those assets.

Why Should Landlords' Misfortune Concern a Tenant?

Among other actions that a foreclosing lender may take to enhance property value will be the termination (where the tenant does not have a non-disturbance right from that lender) of 1) tenant leases having rental rates below current market, and 2) selected leases of tenants viewed as not sufficiently creditworthy. Many relatively smaller tenant leases will be at risk for such termination.

What Can a Tenant Do?

For protection against this coming reality tenants need to focus, now more than ever, on making sure that they have current subordination and non-disturbance agreements ("SNDAs") in place that appropriately protect the tenant's continued occupancy. A SNDA is a wholly separate document from the lease, and needs to be signed by both the landlord's mortgage lender and the tenant. Frequently, but not always, they are also signed by the landlord.

Many tenants are not aware of the importance of SNDAs, and often sign them without thought or review when form SNDAs are received from landlords with instructions that they be signed ASAP - per the terms of the typical lease, SNDAs are to be signed within ten to fifteen days after receipt by the tenant. This is a mistake since SNDAs should not be viewed as a "routine" or "housekeeping" matter. Rather, proposed SNDAs should be carefully reviewed by the tenant and its legal counsel before signing, no matter what comforting statements are made by the property's management. Just as bad, many smaller tenants never seek nor receive SNDAs with their landlord's lender.

As a starting point, tenants are cautioned to get language in their lease requiring the landlord to exercise reasonably diligent efforts to cause the mortgage lender(s), both current and future, to provide the tenant benefit of "non-disturbance rights" (explained further, below).

The Purpose and Importance of the SNDA

The purpose of SNDAs and the mortgage lender's agenda. SNDAs come into the picture whenever the landlord takes out financing on its property, and the building is third party occupied (has tenants). Where there is no financing on a building (100% equity) SNDAs are generally not needed – there is an exception, though, in the case of ground leases. The landlord's lender will usually make sure that most or all the tenants in the financed building sign the lender's form of SNDA.

The lender's objective is to have the tenant(s) agree that the lease is "subordinate" to the lender's security interest in the property – this gives the lender's interest "priority" over the lease. This step is typically a critical pre-condition to the funding of the financing (or refinancing) on the building. The lender will also insist on SNDA language that requires the tenant to "attorn" to that lender if there is a foreclosure on the property – meaning that the tenant is obligated to pay rent directly to the lender after the tenant's receipt of a foreclosure notice respecting the building's mortgage.

When new financing on a building is in the process, the tenant will usually, by virtue of its having received a form of SNDA for its signature, be put on notice that a refinance or additional mortgage lender is acquiring a security lien (deed of trust) on the building in which that tenant occupies space.

The Tenants Objectives

When a new tenant signs a lease for a building already covered by an existing mortgage deed of trust, that later lease is automatically, as a matter of law, subordinate to the mortgage without need for an SNDA. In those situations it is critical that a tenant negotiating a new lease get a requirement in its lease for the landlord to use diligent efforts to have its lender provide and sign a SNDA protecting the tenant's continued occupancy. That SNDA needs to be given concurrently with, or immediately after, the signing of the new lease. The lease language also needs to provide that a SNDA will be forthcoming if there is a future refinancing or further financing being placed on the building.

Additionally, periodic inquiry by the tenant (especially smaller tenants) of its property management is a good idea toward making sure that the tenant has an updated SNDA with respect to any new lenders on the building of which the tenant may otherwise not be aware of.

Review and negotiate. Many favorable changes to a form SNDA can often be had just by asking. When reviewing the proposed form of SNDA, tenant's legal counsel will make sure that the SNDA contains lender recognition of the tenant's continuing occupancy rights, and provides for the lender's commitment that not to terminate that lease (and tenant's occupancy rights) just because the foreclosing lender's security interest in the property is "superior" to the tenant's lease. These protective provisions provide the critical "non-disturbance" rights. Without a non-disturbance commitment a foreclosing lender could elect to terminate the tenant's lease, and 1) force that tenant to enter into a new lease on less favorable economic terms just to stay in the space, or 2) immediately have to locate to other space. Needless to say, proper non-disturbance rights in a SNDA are essential to avoid such an welcome crisis for the tenant.

Depending on the circumstances and leverage of a particular tenant, there are a host of other protective measures that a tenant may need to have in place via a SNDA, including a restriction on the lender's right to preemptively receive insurance proceeds from casualty insurance policies. The objective here is to preserve the landlord's obligation to rebuild and restore the leased space and building after a casualty event, and to make sure that the landlord has the insurance money to do so. This concern is more typical for tenants that are single or majority users of a facility, for retail space users that have accumulated goodwill in their location, and in the case of ground leases.

However, the primary focus all tenants need to have addressed in a SNDA are, again, the protection of continuing occupancy rights, and the commitment that the succeeding landlord (foreclosing lender, or purchaser in lieu of foreclosure) will honor the terms of the tenant's lease on a post foreclosure basis.

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