

QuickCounsel

The Benefits of Subordination, Non-Disturbance and Attornment Agreements

By Joseph Grignano and Iris Tam, Blake, Cassels & Graydon LLP



...and its Real Estate Practice Group

Overview

In entering into a new lease and establishing its premises at a new location, a tenant will likely have invested a considerable amount of money in its premises for leasehold improvements and will very often view its new business location as critical to its operations. In uncertain economic times, if the tenant's landlord defaults under its obligations to its mortgage lender, depending upon the relative priorities between the tenant's lease and the lender's mortgage, the tenant may risk being evicted and suffering significant disruption to its operations and financial loss, even though the tenant has not defaulted in its obligations contained in its lease. From the tenant's point of view, this hardly seems fair, but this is exactly what can happen where the lease is subordinate to the mortgage and the lender elects to enforce security following a loan default by the landlord.

Lease Priority

Why is this the result? In the situation where the lease is subordinate to the mortgage, when a landlord, whose property is already encumbered by a mortgage, enters into a lease with a new tenant, all the landlord has is an "equity of redemption" which may be "foreclosed" or extinguished by the lender following loan default by the landlord and lender enforcement of its mortgage. Absent an agreement between the lender and the tenant, the tenant is in no better position than the landlord and, accordingly, bears the risk of having its leasehold interest in the property foreclosed or extinguished as a part of the lender's enforcement proceedings. Priority in favour of the lender is, however, a two-edged sword.

Attornment

If a mortgage has priority over a lease, upon loan default, and enforcement by the lender resulting in taking possession of the property, the tenant is in turn free to leave. Case law has confirmed that a tenant, subsequent in priority, may be permitted to escape its long-term, above-market lease obligations upon the completion of a foreclosure by a lender

or otherwise upon the lender entering into possession. Consequently, in a soft leasing market, where the lender would wish to ensure a steady rental income stream, priority of the mortgage over the tenant's lease may, in fact, subvert the lender's desires. The lender should be asking the tenant to "attorn" to the lender in these circumstances. When a tenant attorns to the lender, the tenant is effectively promising to recognize the lender as its landlord upon default of the landlord's loan obligations. Attornment would consequently protect the lender from the risk of the tenant vacating when the tenant has been paying above-market rent for the leased property. A well-drafted attornment clause will include an obligation of the tenant to attorn to any successor in title including any purchaser the lender might sell the property to following or as part of the exercise of the lender's loan enforcement remedies.

Prior Lease

On the other hand, if a landlord has entered into a lease with the tenant and thereafter executes and delivers a mortgage in favour of a lender, all the landlord has done is mortgage its "reversion" in the property previously leased to the tenant. Absent an agreement between the tenant and the lender, following a loan default by the landlord, if the lender elects to enforce its security, the lender is bound to honour the tenant's right to possession and certain other provisions contained in the lease, to the extent such provisions "run with the land". In these circumstances, having priority over the mortgage the tenant enjoys "security of tenure" and is not liable to be evicted from its premises by the lender following the lender's loan enforcement, provided the tenant performs its obligations under the lease. At the same time, the tenant is not entitled to walk away from its obligations under the lease just because the lender has stepped into the shoes of the landlord. The reason is the tenant's tenure at the premises has not been jeopardized by the lender's mortgage enforcement procedures. Accordingly, both the tenant and the lender must honour the lease following foreclosure.

Subordination

Accordingly, as illustrated by the two examples set out above, the rights of the tenant greatly depend upon whether it has "priority" over the lender's mortgage. This tenant priority may be lost (a) in accordance with the terms of the lease or (b) pursuant to the provisions of a subordination agreement. In many leases, the tenant has agreed to a provision stating that "the tenant hereby subordinates its lease to any present or future mortgage made by the landlord registered against title to the property". Such an "automatic subordination" clause, without corresponding "non-disturbance" protection, could severely undermine the rights of the tenant in a landlord loan default situation. Whether or not an automatic subordination clause is contained in the lease, landlords are very often met with a requirement in their mortgage loan financing commitment to obtain subordination agreements from all tenants of the property as a condition to the first advance of the mortgage loan. Many lenders wish to have such a prior position so that they may elect to "pick and choose" which of the leases the lender will agree to honour if a loan default occurs. Lenders may have a variety of legitimate reasons for wanting to enjoy such flexibility, including freeing the property from non-arms' length owner-related leases or "problem" tenants that are driving down the value of the property, or simply to remove tenants entitled to pay less than the current market rents in the hope of replacing them with current market deals.

Non-Disturbance

When faced with either subordination requirements in the lease or landlord requests for subordination, a tenant should seek the protections afforded by a non-disturbance agreement. It is prudent for the tenant to obtain a non-disturbance agreement from any existing mortgage lender holding a mortgage on the property when the lease is executed. Additionally, the tenant should avoid agreeing to "automatic subordination" clauses that could undercut its priority vis-à-vis a subsequent mortgage lender or modify such provision to state that it shall only become effective after the lender has executed and delivered a non-disturbance agreement in favour of the tenant. A non-disturbance agreement will create a direct contractual relationship between the tenant and the lender. It will provide that, upon loan enforcement, the lender will not disturb the tenant's possession and quiet enjoyment of the leased premises on

the terms of the lease for so long as the tenant continues to pay rent and otherwise complies with the terms and conditions of the lease. Accordingly, for all practical purposes, with respect to the issue of security of tenure of the premises, a non-disturbance agreement restores the tenant to the same position as it would have been in had the lease continued to have priority over the mortgage and places the lender in the same position as a lender enforcing security on a property with a prior ranking unsubordinated lease.

(a) Simple Non-Disturbance vs. Being Bound by Lease

There are, however, two types of non-disturbance agreements:

Lenders may simply agree not to remove the tenant or otherwise disturb the tenant's use and enjoyment of the premises if they realize on their security, which has been discussed above; and

Lenders may go one step further and also covenant to be bound by the terms and conditions set out in the lease should they assume possession of the property.

Clearly, the second type of non-disturbance agreements is of greater benefit to tenants as it creates privity of contract between the tenant and lender in respect of the lease. Where a tenant is not successful at obtaining a covenant by the lender to be bound by the terms of the lease, the tenant may not be able to enforce as against the lender collateral rights that the tenant has bargained for with the landlord unless such rights "run with the land". There is, unfortunately, much uncertainty in the common law as to which provisions of a lease run with the land. What is certain, however, is that only some, but not all, of the landlord's obligations set out in the lease run with the land.

(b) Altering Rights which would Otherwise be Enjoyed by Tenants

Most lenders try to extricate themselves from certain aspects of the relationship which exists between a tenant and its landlord. Accordingly, a tenant may be forced to concede some of the rights and benefits which it would otherwise enjoy as against its landlord when entering into a non-disturbance agreement with the lender. Set out below are some of the more common examples:

The Equities or State of Accounts Between Landlord and Tenant - Many non-disturbance agreements provide that the lender going into possession will not be bound by the equities or state of accounts that exist between the tenant and its landlord. Specifically, many such agreements stipulate that the lender will not be bound by any prepaid rents, security deposits or other sums that may be payable by the landlord to the tenant. Additionally, tenants are often required to waive any rights of set-off, defences or claims which they may be entitled to assert against their landlord. These provisions are unfair to the tenant and should be resisted whenever possible.

Lease Amendments, Assignments and Subleases, Terminations and Surrenders - Lenders frequently seek agreements from tenants to the effect that the lender will not be bound by any amendments to the lease made without its consent. This will often be expanded to include other changes to the landlord-tenant relationship of which the lender is unaware or over which it had no input, such as lease terminations, surrenders and assignments and subleases. Such consent provisions are often problematic, as they are almost always overlooked, with the result that the tenant may lose the benefit of an amendment which it had bargained for with the landlord. In a lease surrender or termination scenario, a tenant may find itself in the precarious position of being liable to the lender long after the tenant has vacated the premises with the legitimate expectation that its obligations had come to an end. The tenant, having received notice of the existence of the mortgage, generally accompanied by a collateral assignment of leases, knows that the landlord no longer, by itself, has the full right to make amendments to the lease which will be binding on the lender, unless the lender has consented to or joined in the amendment. A tenant should exclude from any approval requirement any amendment that arises out of an exercise of tenant rights contained in the lease (such as an option to renew or extend the lease).

Collateral Lease Rights and Financial Obligations - The lender may also try to remove certain collateral rights,

such as rights of first offer and refusal and options to purchase, for the benefit of the tenant. Tenants should be wary of agreeing to waive such rights or provisions. It would not be fair to a tenant which has relied on such collateral rights as a material inducement to enter into the lease. In other cases, the lender will try to eliminate potential financial obligations such as landlord's construction obligations and tenant allowances. Where the cost of these obligations has been built into the minimum rent payable by the tenant over the term, it would again not be fair to expect a tenant to give up such rights and the tenant should strongly resist. In such a situation, it would be advisable for the tenant to negotiate a reduction in minimum rent or a right of set-off where the lender refuses to expend money in connection with the lease. Lenders will seek to protect themselves from liability for any act or omission of the landlord arising prior to the date of the lender taking control of the landlord's interest in the property. The tenant should try to qualify this by specifying to the extent that such act or omission is of a continuing nature and the lender has been given notice and opportunity to cure the same.

Notice and Opportunity to Cure - The lender may seek an agreement by the tenant to give the lender notice of all landlord defaults and an agreement by the tenant not to terminate the lease or exercise abatement or set-off rights until the tenant has given the lender time to cure the default. Some lenders request that the notice and cure rights extend beyond those given the landlord in the lease. The tenant may wish to confine the notice and opportunity rights of the lender to matters that could give rise to termination, abatement, self-help or rent set-off rights.

Insurance Proceeds - The lender may insist that, following the occurrence of an event of damage or destruction, all insurance proceeds be used to pay down the debt rather than repair the property. This is problematic from a tenant's perspective, as although many leases would permit the tenant to terminate its obligations under the lease if the landlord has not rebuilt within a specified period of time, the tenant will nevertheless have lost its strategic location and other benefits of the lease. In certain circumstances, the tenant may find itself in a situation where it is bound to continue to occupy its premises and perform its lease obligations notwithstanding that the property may be untenable in whole or in part.

Additional Resources

[Lease Priority, Attornment and Non-Disturbance Explained](#)

Have an idea for a quick counsel or interested in writing one?

Submit your ideas by filling out our [online topic proposal form](#).

Published June 15, 2009 (Updated on December 9, 2011)

<p>The information in this QuickCounsel should not be construed as legal advice or legal opinion on specific facts and should not be considered representative of the views of its authors, its sponsors, and/or the ACC. This QuickCounsel is not intended as a definitive statement on the subject addressed. Rather, it is intended to serve as a tool providing practical advice and references for the busy in-house practitioner and other readers.</p>

Reprinted with Permission from the Association of Corporate Counsel

2010 All Rights Reserved

www.acc.com

<http://www.acc.com/legalresources/quickcounsel/tbosnaaa.cfm>