Non-Disturbance Agreements for Subtenants;

Approaching the Master Landlord and Lender

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1. Overview.

(A) Traditional Non-Disturbance Agreements.

Whenever a tenant leases space, it runs the risk that it might lose its estate in the event that its landlord defaults under a senior mortgage agreement. The tenant's interest could be extinguished either by reason of the foreclosure of an encumbrance in existence at the time that the parties executed the lease, or even – if the lease includes a subordination clause – by reason of the foreclosure of an encumbrance created after the execution of the lease. A tenant should therefore generally attempt to protect its leasehold interest by entering into a non-disturbance agreement with the mortgagee, concurrently with the execution of the lease. Under such a non-disturbance agreement (often referred to as a recognition agreement), a "mortgagee covenants that, in the event of a foreclosure, the tenant will remain on the leased premises so long as the tenant continues to comply with the terms of the lease and the lease is not in default." (*See* Feinstein & Keyles, *Foreclosure: Subordination, Non-Disturbance and Attornment Agreements* (Aug. 1989) Prob. & Property, 38, 39, cited in *Miscione v. Barton Development Company* (1997) 52 Cal.App.4th 1320, 1327). In fact, "the concept of non-disturbance is frequently intended to refer not only to non-disturbance of the tenant's right of possession, but also to full recognition of all of the tenant's rights under its lease." (*See* Fisher & Goldman, *The Ritual Dance Between Lessee and Lender* (Fall 1995) 30 Real Property, Prob. & Trust J. 355, 357, cited in *Miscione*, 52 Cal.App.4th at 1327).

Traditionally, it has principally been major credit tenants who have been able to obtain such non-disturbance agreements, either in the form of a separate agreement or of a provision in the lease. The non-disturbance agreement assures them that they will be able to retain possession of the leased premises in the event that the landlord-mortgagor's equity of redemption is foreclosed and that their landlord loses title to the mortgaged property. In return for such an agreement, of course, the lender will often insist that the tenant agree to attorn to the lender in the event of the mortgagor's default. Under an attornment clause, a "tenant covenants with the mortgagee that, in the event of foreclosure, the lease will not be extinguished but will continue as a lease between the mortgagee (or any successor to it) and the tenant . . . [; t]he tenant, in other words, agrees to recognize that another party who would not otherwise have privity may enforce the lease agreement as though the third party were originally a beneficiary of the agreement."

(*See* Feinstein & Keyles at 39, cited in *Miscione*, 52 Cal.App.4th at 1327-1328). The parties may also enter into a subordination agreement, whereby "one holding an otherwise senior lien or other real estate interest consents to a reduction in priority *vis-à-vis* another person holding an interest in the same real estate." (*See* Black's Law Dict. (6th ed. 1990) p. 1426, col. 2, cited in *Miscione*, 52 Cal.App.4th at 1327.) Such a subordination clause or agreement will typically provide for the subordination of the tenant's interest to that of any subsequent mortgagee.

A non-disturbance agreement is of particular importance to a tenant, insofar as it will protect the tenant from the considerable expense and inconvenience of being summarily ousted from the leased premises in the event of foreclosure of the landlord-mortgagor's equity of redemption. Of course, such an agreement will be all the more important from the tenant's standpoint if the tenant anticipates that market rental rates may rise over the course of the lease term: in such an event, the non-disturbance agreement not only protects the tenant's continued use and enjoyment of the leased space but protects the tenant's favorable current rental rate. Even if the tenant's negotiated rental rate proves not to be so favorable (as by reason of a collapse in the market rental rates), the non-disturbance agreement is desirable from the tenant's perspective insofar as it leaves him free (in the absence of an attornment agreement) to abandon the premises in the event of a foreclosure if it determines that it can secure a more favorable rate elsewhere.

(B) <u>Subtenants' Reasons For Seeking a Non-Disturbance Agreement</u>.

Tenants therefore have good reason to seek a non-disturbance agreement from their prospective landlords' mortgagees. But prospective subtenants have additional reasons to want such a recognition agreement. A subtenant must of course, for all the reasons discussed above, prepare for the eventuality that a termination of the master landlord's estate (by reason of a default under a mortgage agreement) might effect a termination of its estate. But in addition, any prospective subtenant must confront the possibility that, should it enter into a given sublease, its estate could be extinguished by a termination of the sublandlord's estate as well. The subtenant's estate could of course be terminated as a result of the sublandlord's breach under the master lease. *See Fifth and Broadway Partnership v. Kimny, Inc.* (1980) 102 Cal.App.3d 195, 201. And in the event of the direct tenant's bankruptcy, its rejection of the master lease under § 365 of the Bankruptcy Code would constitute a breach as well. *See, e.g.*, Bankruptcy Code, 11 U.S.C.A., § 365(g); *In re Austin Development Company* (5th Cir. 1994) 19 F.3d 1077, 1082. In the Ninth Circuit, such a breach would effect an actual termination of the rejected lease, permitting the bankruptcy court to compel immediate surrender of the leased premises by the trustee and by any third parties claiming through the debtor. *See, e.g., In re McSheridan* (9th Cir.BAP 1995) 184 B.R. 91, 102; *George v. County of San Luis Obispo* (2000) 78 Cal.App.4th 1048, 1053. Finally, in some jurisdictions, the subtenant runs the risk that its leasehold interest might be jeopardized in the event that the sublandlord *voluntarily* abandoned the Premises; in California, however, a tenant's voluntary surrender of the leased premises to the master lessor will generally not destroy the subtenant's estate: *see Chumash Hill Properties, Inc. v. Peram* (1995) 39 Cal.App.4th 1226, 1233, *citing Buttner v. Kasser* (1912) 19 Cal.App. 755, 760.

In sum, subtenants have particular incentives to seek non-disturbance (recognition) agreements. Not only do they typically want to be able to preserve their estate in the event that the master landlord defaults on its mortgage agreement, but they also want protection in the

event that the sublandlord defaults on the master lease and its estate is involuntarily terminated, and in some states at least, in the event that the sublandlord voluntarily abandons the Premises. In other words, a prospective sublessee has reason to want two separate forms of non-disturbance agreement: (i) a non-disturbance agreement from the master landlord's mortgagee, and (ii) a non-disturbance agreement from the master landlord, preferably one that provides protection even in the event of the sublandlord's voluntary surrender of the premises.

2. Landlords' and Lenders' Incentives to Grant Non-Disturbance Agreements to Subtenants.

The question is whether the subtenant will have sufficient leverage to obtain such concessions from either party. In fact, prospective subtenants have had increasing success in obtaining such concessions from master landlords and their lenders. There are essentially two reasons for this increased willingness to engage in non-disturbance agreements. The first is that, until relatively recently, and in large part because of the decision of *Dover Mobile Estates v. Fiber Form Products* (1990) 220 Cal.App.3d 1494, many lenders suspected that attornment provisions would be unenforceable in the absence of a non-disturbance agreement. The second reason has to do with the fact that periods of economic downturn generate more subleasing activity. In the current economic cycle, landlords and their lenders are under considerable pressure from down-sizing tenants to accommodate their transfer requests and may therefore agree to accord non-disturbance rights to prospective subtenants, in order to retain their direct tenants at favorable rental rates. Both of these developments are discussed below.

(A) Enforceability of Attornment Clauses in the Absence of a Non-Disturbance Agreement.

(i) The *Dover* Case.

In the case of *Dover Mobile Estates*, the tenant-defendant had entered into a lease which included an explicit subordination clause, rendering the lease subordinate to any subsequent deeds of trust or mortgages. The lease did not, however, include a non-disturbance provision and does not appear (although the decision does not explicitly so state) to have included an attornment clause. The landlord later encumbered the property with a second deed of trust and ultimately defaulted. Some time after the foreclosure sale, having failed to come to an agreement with the foreclosure purchaser as to a proposed rent adjustment, the tenant surrendered the premises. When the foreclosure purchaser brought an action to recover rent, the former tenant asserted that the foreclosure sale had extinguished the lease by virtue of the subordination provision, and the court ruled for the defendant. In so ruling, the *Dover* court re-affirmed the general rule that a trustee's sale *automatically* terminates a junior lease (rather than giving the foreclosure purchaser the option of so terminating). When the tenant initially held over after the foreclosure sale, in attempting to negotiate a rent reduction with the new landlord, it therefore did so as a "tenant-at-sufferance," under the equivalent of a month-to-month tenancy, terminable by either party on thirty days' notice.

In reaching this conclusion, the court also recited, by way of dictum, that the tenant under such a subordinate lease could have obtained protection against automatic termination by requiring its landlord to obtain from the mortgagee a non-disturbance agreement in the tenant's

favor. In light of this comment, and in light of the repeated emphasis that the court had placed on the fact that a foreclosure sale automatically "extinguishes" a subordinate lease, many commentators interpreted the decision to have suggested that, in the absence of a non-disturbance clause, an attornment provision might not suffice to prevent extinguishment of the subordinate lease upon foreclosure sale. Mortgagees therefore had reason to fear that they might not be able to bind a subordinate tenant to a lease agreement in the event of foreclosure unless they agreed to extend a non-disturbance agreement in return for an attornment clause. This right – to bind the tenant to the lease in the event of foreclosure – would of course be particularly valuable to the lender in a depressed market, insofar as the mortgagee would be able to obtain a higher price at sale, and so would be more likely to recover its investment, with respect to a property that was generating steady income.

(ii) The *Miscione* and *Principal Mutual Life* Cases.

Two subsequent decisions have cast doubt on this interpretation, however, and appear to suggest that an attornment provision will be readily enforceable in the absence of a non-disturbance agreement. The *Miscione* case, *see supra*, involved, *inter alia*, an action for breach of an office lease which contained both an attornment clause and a subordination and non-disturbance clause. The case again involved the question whether a subordinate lease (and the tenants' obligations thereunder) would survive a foreclosure sale upon default of a senior encumbrance, and in this instance the court ruled for the successor landlord. The court distinguished *Dover* on the ground that the lease in that case had included no attornment provision and recited that in this case, "in contrast, the attornment clause fixed the rights of the parties after the foreclosure." *See Miscione*, 52 Cal.App.4th at 1329. The decision therefore provided at least some degree of comfort to lenders, insofar as it premised the survival of the lease specifically on the inclusion of the attornment clause, rather than on the combined inclusion of attornment and non-disturbance provisions. However, mortgagees still had some cause for concern insofar as a dissenting judge had contested the majority's differentiation of *Dover*, pointing out, quite rightly, that it was not at all clear from the text of that published opinion whether or not the lease in that case had included an attornment provision. The dissenting justice surmised that "it [was] more likely that there was an attornment clause in the *Dover* lease, but [that] the court did not discuss it because no one thought to give it the undue emphasis and strained construction given the attornment clause here." *See Miscione*, 52 Cal.App.4th at 1339.

Lenders could take comfort, however, in the subsequent decision of *Principal Mutual Life Insurance Company v. Vars, Pave, McCord & Freedman* (1998) 65 Cal.App.4th 1469, in which the Court of Appeal for the Second District reaffirmed the view that an attornment provision would cause a subordinate lease to survive a foreclosure sale, even in the absence of a non-disturbance agreement. In this case, the defendants had entered into a lease which included subordination and attornment clauses but which did *not* include a non-disturbance provision (*see Principal Mutual Life*, 65 Cal.App.4th at 1479), and were again deemed bound to the lease after foreclosure by virtue of the attornment provision. In this case, the facts were in fact somewhat more perilous from the lender's standpoint than those involved in *Miscione*. The attornment clause at issue differed from that involved in *Miscione* in that it did not automatically provide for the continued existence of the subordinated lease upon foreclosure but provided rather that upon request the tenant would enter into a *new* lease, incorporating the terms of the lease extinguished

by the foreclosure sale. The court nonetheless upheld the attornment clause by reference to the contract law doctrine of third-party beneficiaries, notwithstanding the fact that – in a sense – the clause had itself contemplated that the lease would be extinguished upon foreclosure sale. Most important, however, for our purposes is the fact that the court unequivocally vindicated the traditional view that an attornment clause will be enforceable even in the absence of a non-disturbance agreement. Alluding specifically to *Dover*, the majority stated as follows: "[n]or did *Dover* hold, as appellants suggest, that a non-disturbance clause is essential to the validity of an attornment provision." *See Principal Mutual Life*, 65 Cal.App.4th at 1483.

(iii) Conclusion From the Cases.

In sum, notwithstanding some initial confusion in the wake of the *Dover* decision, it now appears indisputable that attornment provisions should be readily enforceable in the absence of a non-disturbance agreement; and while all of these cases involved the specific issue of a tenant's attornment to a mortgagee (or to a foreclosure purchaser), there is no reason to doubt that the same result would obtain in the case of a subtenant. In other words, it appears that a subtenant could be readily compelled to attorn either to the master landlord or to the master landlord's mortgagee (or to a third-party foreclosure purchaser), regardless of whether such parties had consented to the execution of a non-disturbance agreement.

This begs the question: why should a master landlord or a mortgagee ever consent to the execution of a non-disturbance agreement, if a subtenant can be compelled to attorn in the absence of such an agreement?

(B) <u>Benefits to Landlords and Lenders of Extending Recognition to Subtenants</u>.

(i) Preventing Default by the Direct Tenant.

The answer is simply that it will often be in their interest to do so. In periods of economic slow-down, tenants tend to downsize and therefore come under pressure to sublease some of their excess space. And with the increase in vacancies and in subleasing activity that typically accompanies such an economic slow-down, tenants may not be able to attract prospective sublessees or to consummate sublease negotiations unless they agree to co-operate in obtaining recognition agreements from their landlords and their landlords' mortgagees. The danger, from the standpoint of landlord and lender, is that if such a down-sizing tenant fails to secure a subtenancy for its unwanted space, it may no longer be able to afford (or may claim that it can no longer afford) to abide by its lease and may abandon the premises. The landlord (and its lender) would then be left with the unpleasant necessity (i) of attempting to re-let the space in a depressed, tenants' market, and/or (ii) of pursuing, at considerable cost and inconvenience, a possibly toothless judgment against the defaulting tenant, in which event the tenant would almost certainly claim that the abandonment had been triggered to some degree by the landlord's/lender's own intransigence in failing to consent to a recognition agreement with a prospective subtenant. In a period of increased subleasing activity, the landlord and its mortgagee therefore often stand to lose very little by agreeing to execute such a non-disturbance agreement on behalf of a prospective subtenant. Such a concession not only increases the landlord's chances of retaining its direct tenant at an above-market rate, but increases its chances

of recovering against such a direct tenant in court in the event that the tenant ultimately defaults under the lease agreement.

(ii) Benefits in the Event of Default by the Direct Tenant.

Granted, then, the conferral of a non-disturbance agreement tends to lessen the risk of default by the direct tenant, by permitting the tenant to salvage some value in its unneeded space. But what if the direct tenant nonetheless ultimately defaults anyway? It might not then appear to be in the landlord's or the lender's interest to be bound to such a subtenancy. For example, imagine that a commercial landlord refuses to execute such a recognition agreement, and that the direct tenant's proposed sublease nonetheless goes through. Imagine then that the direct tenant later defaults under the terms of its lease agreement. The landlord would then be free either to negotiate a direct lease with the prior subtenant (whose subtenancy would have been extinguished by virtue of the termination of the master lease) or to proceed to market the property to any other third party at the then current fair market rental value. But if the landlord had agreed to execute a non-disturbance agreement on behalf of the subtenant, it would be bound by the terms of the subtenancy, notwithstanding any increase in the current market rental rate and notwithstanding the fact that the perpetuation of the subtenancy might impair the marketability of any remaining space to third parties. The lender might have even greater reservations with respect to such an agreement, insofar as it could find itself bound to a below-market subtenancy *not only* in the event that the master lessor defaulted under the mortgage agreement *but also* in the event that the sub-lessor defaulted under the master lease.

And yet the fact remains that, at least in the current economic climate, it may be to the advantage of landlord and lender to agree to such a concession, even taking into account the possibility that the direct tenant might ultimately default. From the standpoint of the landlord, even in the event that the tenant/sublessor defaulted under the master lease, and that the sublessee was therefore entitled, by virtue of a recognition agreement, to remain in possession at a below market rental, the lower rental would nonetheless be likely to provide a rate of return substantially similar to that which the landlord could obtain from a new third-party tenant, after taking into account down time, commissions, landlord-financed alterations and other rental concessions, which expenses would be likely to be substantial in a tenants' market. And of course, in a down cycle, the landlord would in no way be assured that the market rental rate would exceed the subtenant's negotiated rent at the time of the tenant's default. In other words, the subtenant's "below market" rental rate might prove to be equivalent to or slightly in excess of any market rate prevailing at the time of termination of the master lease. By the same token, it may be to the lender's advantage in a depressed market for the subtenancy to survive the foreclosure of the mortgage or the termination of the master lease: in such a case, it is at least assured of a steady income stream which can be applied toward the mortgagor's loan payments (in the event of the termination of the master lease) or which would render the property more readily marketable in the event of foreclosure sale (in the event of the mortgagor's default under the mortgage agreement).

Of course, the master landlord's and the lender's primary incentive in granting such a recognition agreement to a prospective subtenant will generally have been to accommodate a tenant under a lucrative direct lease. This incentive will be particularly acute when the direct tenant is perceived to be in financial difficulty and when there is therefore perceived to be a

particularly great risk that it might default under the lease. To the extent, then, that the master landlord's and lender's main justification in granting such a recognition agreement to the subtenant is to help alleviate a perceived financial difficulty on the part of the direct tenant (and to help prevent its default under the direct lease), they should also anticipate the possibility of the direct tenant's future bankruptcy. They should, in other words, draft the non-disturbance agreement in such a way as to specifically address the parties' respective rights and obligations in the event that the bankrupt sublessor rejects the master lease under § 365 of the Bankruptcy Code. And again, the parties' interest may tend to converge: it may benefit both parties to have the non-disturbance agreement specifically extend not only to instances of involuntary termination of the master lease by reason of the direct tenant's default, but *also* to the direct tenant's rejection of the master lease in the course of a bankruptcy proceeding. In the event of the direct tenant's bankruptcy, the master lessor and lender might indeed prefer to automatically retain some level of guaranteed return on at least a portion of the leased space.

(iii) Additional Considerations.

Both the landlord and the mortgagee will be in a strong position to negotiate, in return for their execution of a recognition agreement, some form of automatic increase in the subtenant's rental obligations in the event that the recognition agreement is triggered by some event of default. The landlord would of course seek to have the increase go into effect upon termination of the master lease, while the lender would typically be concerned to have the increase go into effect either upon termination of the master lease or upon foreclosure of the mortgage. The lender and landlord might agree, for example, that the "non-disturbed" subtenant's rent should be increased to the then prevailing market rental rate, if such exceeds the subtenant's rental obligations as of the date of termination of the senior interest. The subtenant, for its part, would want to restrict any provision for automatic rent increase and might attempt to negotiate some form of adjustment whereby, in the event of termination of the master lease or of foreclosure of the mortgage, its Base Rent obligations would be set at the lower of the then prevailing market rental rate and the sublessor's "per square foot" rental rate, but (as an obvious concession by the subtenant) in no event lower than the subtenant's face sublease rate.

In addition, of course, the landlord and lender should confirm, before conceding to any form of recognition, that the subtenant's rights and obligations under the proposed sublease are reasonably similar to those accorded the direct tenant under the master lease. Likewise, insofar as any recognition agreement might ultimately entitle the proposed subtenant to retain possession as a direct tenant, the sublease agreement should generally not impose any burdens or obligations on the master landlord or its successors not contemplated under the master lease.

Finally, the master landlord and its mortgagee may want the proposed sublease (and/or the non-disturbance agreement) to specifically address the question of the parties' respective rights and obligations in the event of the direct tenant's bankruptcy. Indeed, for the reasons discussed above, it will often make sense for the parties to provide for recognition not only in the event of involuntary termination of the master lease by reason of the direct tenant's default but also in the event of the direct tenant's rejection of the master lease under § 365 of the Bankruptcy Code. The parties should also determine whether, under applicable state law, the subtenancy would automatically survive the direct tenant's abandonment or voluntary surrender of the leased

premises and should determine, in the event that it does not, whether they want the recognition agreement to govern such instances of voluntary surrender as well.

3. Failure by Sublessee to Obtain a Recognition Agreement.

It should be kept in mind, however, that all is not lost from the standpoint of a prospective sublessor if it fails to obtain some form of recognition agreement from the master landlord and/or the mortgagee. A landlord's or a lender's refusal to enter into such an agreement should not necessarily kill the deal. If a prospective sublessee believed that the commercial real estate market had not yet bottomed out, it might welcome the landlord's or lender's refusal as an excuse to reject a proposed attornment provision, thereby entitling it, without liability, to quit the premises upon termination of a senior interest and to seek less expensive accommodation elsewhere. But even if a prospective subtenant sought some of the security of a recognition agreement, it might not have to rely entirely on a formal concession from the master landlord or its lender. It might, for example, already be protected from termination in the event of mortgage foreclosure under the terms of a master lease's non-disturbance clause. And it could obtain some level of protection with respect to the eventuality of the sublessor's default by negotiating some restriction in the sublessor's freedom to voluntarily terminate the master lease. In some states, such as California, such is not really a matter for concern insofar as a subtenancy generally survives the sublessor's voluntary surrender of the premises. But in other jurisdictions, if the subtenant had failed to obtain a non-disturbance agreement, it might nonetheless attempt to restrict the sublandlord's ability to voluntarily terminate the direct lease without the subtenant's consent, for example by limiting such rights to situations involving casualty or condemnation. *See* Herz & Wohl, *Subleases: The Same Thing as Leases, Only Different* (Fall 2000) Real Property, Prob. & Trust J. 667, 684. Of course, the subtenant should also resist any provision in the sublease limiting the sublandlord's liability to its interest in the building (*i.e.*, to the direct lease), see Herz & Wohl at 688, insofar as such a provision would in effect deprive the sublessee of any remedy *vis-à-vis* the sublessor in the event either of the sublessor's default under the master lease or of the sublessor's voluntary surrender of the premises.

4. Conclusion.

Nonetheless, the fact remains that, at least in the current economic climate, subtenants should have a reasonable degree of success in obtaining such recognition agreements. On the one hand, as a result of some of the market forces discussed above, letters of intent are increasingly likely to contemplate that direct tenants may someday need to sublease, and may therefore require landlords to agree in advance to accord recognition agreements to future subtenants of some reasonable size and layout (such as full floor units at the extreme ends of multi-floor premises). And for their part, landlords and lenders often have good reason to accommodate such requests. Depending on the circumstances, it may be in the master landlord's best interest to accommodate the prospective subtenant with some form of recognition agreement, if only in order to help retain its current tenant (the sublessor) at an above-market rental rate in a period of economic slow-down. The lender might do well to accede to such requests as well, and for largely the same reasons: it wants to ensure that the property continues to be profitably occupied, both in order to ensure that the mortgagor will continue to be able to meet its mortgage payments and in order to ensure that, in the event of the mortgagor's default, the property will be able to garner a sufficient price at foreclosure sale in order for it to comfortably recoup its investment. While the principal argument for such a concession may be that it helps landlords and lenders maximize their chances of retaining a direct tenant at above-market rent, we have seen that a recognition agreement can be negotiated in such a way as to be economically painless, from a then current market rate standpoint, even in the event that the direct tenant ultimately defaults.