

Commercial Lease Tenants and Real Property Foreclosures

Judicial and nonjudicial foreclosures involving commercial properties remain prevalent in Oregon with few signs of any imminent reduction. The leasing of commercial properties will continue, of course, along with the attendant risks to business owners of a foreclosure action. Proper advice to a potential tenant will mitigate the risks and, in the case of some businesses, may make or break a company's survival in a foreclosure. This article explores some of the issues that should be addressed to reduce a business owner/tenant's risks in a nonjudicial foreclosure of commercial property.

What Is the Effect of a Foreclosure?

This article explores issues pertaining only to nonjudicial foreclosures. Actions against guarantors and for judicial foreclosure, in which case the lender will be seeking a deficiency judgment, involve issues regarding priority, redemption rights, and claims that are outside the scope of this article. In a nonjudicial foreclosure, the lender is not entitled to a deficiency judgment against the landlord, there are no redemption rights, and the lender simply is seeking to either take control of the property or obtain funds from a third-party purchaser. (Separate issues pertain to guarantors.)

- If there is an existing secured loan against the real property, the security instrument (almost always a trust deed in Oregon) securing the loan will have priority over the tenant's leasehold interest, and, upon foreclosure, the leasehold interest would be extinguished.

Practice Tip: Although the foreclosure

would be a default of the landlord under the lease, most well-crafted commercial leases also have a provision that limits the landlord's liability to the landlord's interest in the property, so if the landlord's interest is foreclosed, there is no further claim by the commercial tenant against the landlord. A commercial tenant who seeks to retain additional rights against the landlord should closely review this provision.

- If there is no existing secured loan against the property, then the leasehold interest will have priority over any subsequent recorded mortgage or trust deed. If there is no requirement to subordinate, then the tenant has leverage in dealing with the landlord and the proposed lender. However, any well-crafted commercial lease will have a provision requiring that the tenant enter into some form of Subordination, Nondisturbance and Attornment (SNDA) agreement with the landlord and the proposed lender.

What Can You Do to Protect Your Commercial Tenant Client?

- **Knowledge Is King.** In this economy, you should strongly consider the benefits of obtaining a lot book report. Most title companies will provide lot book reports under these circumstances for less than \$500, depending on the size and scope of the property. If a commercial tenant is investing thousands or tens of thousands in improvements, advertising, and other start-up costs, it may well be worth the hundreds of dollars it

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will cost to ascertain the property status. Not only will a lot book report identify any judgments or other monetary encumbrances against the real property, which will give you some insight into the landlord's financial situation, you will be able to ascertain if there are any loans secured by the real property. Even without the cooperation of the landlord or the lender, you will be able to ascertain general terms and conditions of the loan(s), including the loan amount, the loan term, and any modifications (if material, since a failure to record may affect priority). If any loans do exist, you also may be able to ascertain the status of those loans (e.g., any pending or even rescinded foreclosure actions). The commercial tenant would be well advised to ascertain the work-out plans of the potential landlord before entering into any long-term lease. If the property is free and clear, that also may be a consideration in the negotiating process.

Practice Tip: Many county recorders now provide online access to real property records, including records of any trust deeds, modifications, and notices of default and rescissions of the same. These can be accessed quickly and may provide some insights for your clients before incurring the cost of ordering a title report.

- **The Merits of a Strong SNDA.** The costs and benefits of an SNDA agreement should be and, in some cases, will need to be explored many times during the leasing process, including at the inception if there is an existing lender. The SNDA will provide a set of terms to govern the relationship between the landlord, tenant, and lender in a foreclosure.

- ▶ **Subordination.** The subordination provision typically provides that the lease is subordinate in right, interest, and lien, for all purposes, to the lender and to all renewals, modifications, consolidations, replacements, and extensions thereof. Most commercial leases provide that the lease will be subordinate to any existing or future trust deeds granted by the landlord, and most lenders will insist on a subordination of the lease to the lender. The key question, then, is what saving provisions can be inserted, if any, pursuant to a nondisturbance and/or attornment clause.

- ▶ **Nondisturbance.** Generally, the nondisturbance provision works for the benefit of the tenant. This provision typically allows the tenant, so long as it is not in default under the lease beyond any applicable cure period, to continue the lease notwithstanding the landlord's default. This provision is an agreement between the lender and the tenant that enables the tenant to continue with the lease if the lender forecloses. If the lease provides for automatic subordination by the tenant in the event of a lender trust deed against the subject property, or if a new lender insists on subordination of a lease before the providing of a lease, it is critical that the tenant insist on a nondisturbance

provision. From a lender's perspective, it is critical to then link the nondisturbance with the attornment. Otherwise, the tenant is in a position to leave or hold the lender to the lease, as the market dictates.

- ▶ **Attornment.** An attornment clause generally requires a tenant to continue the existing lease under a new landlord after a foreclosure. The new landlord may be the lender, if the lender is the successful bidder at the foreclosure sale, or a third party. From a lender's perspective, an attornment clause will secure the economic value of the leaseholds. From the tenant's perspective, it provides economic certainty in the event of a landlord's default. The precise language of the attornment clause may vary from lease to lease, and from SNDA to SNDA. Therefore, it is critical to look at the specific language of each attornment clause to determine its particular operation. There is no such thing as a "generic" attornment clause. An attornment clause may contain preconditions (e.g., giving notice to a tenant after foreclosure of a continuing obligation). In general, if no preconditions exist in an attornment clause, the attornment operates automatically, and the existing lease will continue to bind both the tenant and the new landlord.

Practice Tip: Many commercial leases and SNDAs fail to include provisions that cover deeds in lieu of foreclosure, which are more and more common. Also, make sure to identify that the tenant shall attorn to and recognize any transferee (e.g., purchaser at a foreclosure sale) on the same terms and conditions of the lease or subject to any carve-outs or preconditions. For example: How will the security deposit be treated, and what are the attendant obligations of any successor landlord? What are the successor landlord's obligations with respect to any offsets or defenses a tenant may have? Is there a need for any additional obligations not otherwise found in the original lease (e.g., indemnification or hold harmless obligations)?

Practice Tip: An SNDA should be catered to your client's perspective and drafted to particularly address specific economic conditions. For example: Will the lender be bound by any agreement that the tenant may have regarding prepaid rent or advances? Is there a risk of collusion between the landlord and the tenant once the landlord gets notice of the foreclosure? Will the lender be bound by any modification of the lease made without the lender's consent (e.g., a reduction in the lease term or a change of monetary obligations)?

- **Record Your Memorandum of Lease.** Oregon recording statutes will establish priority based on either

constructive or, in some cases, actual notice. Constructive notice will be presumed in the event of a properly recorded memorandum of lease. (It is not necessary to record the entire lease.) While most lenders will investigate the status of any leasehold interests notwithstanding the lack of any recording, consider recording a memorandum of lease anyway. Given the significant investment of time and money for most tenants and the increased risks of foreclosure, a strong argument can be made regarding the merits of recording a memorandum of lease.

Conclusion

A commercial tenant seeking to protect its economic interests under present market conditions should review very closely the potential consequences of a landlord foreclosure. The benefits to be gained by reviewing the status of all liens and encumbrances pursuant to a title search, recording the memorandum of lease, and negotiating a strong SNDA (to the extent a commercial lender will allow) will generally far outweigh the costs.

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