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# Commercial Real Estate Financing 2017

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## SNDA's and Subordinate Ground Leases

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Subordination, non-disturbance and attornment agreements (“**SNDA**s”) are most-often evaluated and analyzed in the typical space tenant context. The consequences of executing an SNDA in the context of a ground lease, however, are vastly different and can be much more severe to the tenant. The focus of this Section is on the ability to finance a leasehold estate when the underlying ground lease is subordinate to a mortgage encumbering the fee simple estate.

## **1. AVOID THIS FACT PATTERN**

Consider the following hypothetical:

- a. Your developer client built a shopping center on a parcel of land she leased from the fee owner pursuant to a 99-year ground lease.
- b. You did not negotiate the ground lease, but it contains all the typical provisions and even includes a comprehensive section with excellent leasehold mortgagee protection provisions. The ground lease also includes the following provisions:
  - i. “Fee Mortgages and Subordination: Ground Lessor shall have the right to grant a mortgage on Ground Lessor’s fee simple estate in and to the Property. This Ground Lease is and shall be subordinate to any fee mortgage granted by Ground Lessor, provided that any holder of such fee mortgage shall execute and deliver to Ground Lessee a non-disturbance agreement.”
  - ii. “Casualty and Condemnation Proceeds: Upon the occurrence of any casualty, Ground Lessee shall be entitled to receive all insurance proceeds. Upon the occurrence of any taking of all or any portion of the Property by eminent domain, Ground Lessee shall be entitled to receive proceeds attributable to the value of the Improvements and the value of Ground Lessee’s leasehold estate in the Property so taken. . . .”
  - iii. “Option to Purchase: From and after the 5<sup>th</sup> lease year, the Ground Lessee shall have the right and option to purchase Ground Lessor’s fee simple estate for the sum of \$1,000,000. . . .”
- c. Six months ago, ground lessor obtained a \$1,500,000 loan secured by a mortgage on ground lessor’s fee simple title to the ground leased property. Counsel to the fee mortgagee provided a standard form of SNDA to your client, as the tenant under the Ground Lease. Because an SNDA is a routine document, you gave it to a first year

- associate, who you recently trained to review and negotiate SNDAs in connection with your representation of a space tenant in another shopping center. Your client signs the SNDA, with minimal revisions.
- d. Your client just signed a term sheet for a permanent loan and plans to grant a leasehold mortgage on the ground leased property.

## **2. ROADBLOCKS TO FINANCING THE LEASEHOLD ESTATE WITH A SUBORDINATE GROUND LEASE**

There are three significant issues created by the above fact pattern that make it difficult and expensive, if not impossible, to finance the leasehold estate. Two of those issues could have been avoided when the tenant under the ground lease signed the SNDA. The third issue could only have been avoided when negotiating the ground lease. The three issues are summarized as follows:

- a. Casualty and Condemnation Proceeds. In most ground leases, the tenant leases the land from the landlord and constructs the improvements. Because the tenant paid for the cost of constructing the improvements, the expectation is that the tenant under the ground lease (or its leasehold mortgagee) will receive all insurance proceeds following a casualty and will also receive condemnation proceeds equal to no less than the value of the leasehold improvements and the residual value of the leasehold estate so taken. If the ground lease is subordinate to a fee mortgage, however, either by the express terms of the ground lease or by virtue of an SNDA, the tenant under the ground lease has likely agreed that the fee mortgagee has superior rights to the casualty and condemnation proceeds.<sup>3</sup> This is a

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3. *See, e.g., Miscione v. Barton Dev. Co.*, 61 Cal. Rptr. 2d 280, 285, 52 Cal. App. 4th 1320, 1328 (1997) (“It should be noted that SNDA provisions may alter the rights of the parties not only with respect to foreclosure actions, but also in connection with distribution of insurance proceeds, condemnation awards, and promises made outside the lease.”); Note, however, while the subordination provisions of an SNDA theoretically subordinate the tenant’s leasehold interest to the lender’s mortgage, which would include an interest in condemnation awards, that subordination may be rendered inoperative if the condemnation ousts the tenant from the property, as subordination is usually conditioned on a tenant’s continued enjoyment of the premises. For example, in an unpublished Wisconsin Circuit Court opinion, *HSBC Realty Credit Corp. v. City of Glendale*, No. 04CV010624, slip op. at 23-5 (Wisc. Cir. Ct. May 31, 2005), the tenant had agreed to subordinate the tenant’s lease to the mortgage, but conditioned the subordination on preserving “the covenants, terms and conditions of the [SNDA].” Within the SNDA, the lender had promised the tenant continued occupancy of the premises in the event of an ownership change.

harsh and perhaps unintended consequence, but words matter and it's extremely important to use the right words, even when entering into what some would consider to be a routine document.

Would it have made a difference if the SNDA had limited the extent of the subordination to the "lien of the mortgage" instead of the "terms and conditions of the mortgage"? While many sophisticated tenants are careful to make this distinction when negotiating SNDAs, surprisingly, there is virtually no case law directly addressing this distinction.<sup>4</sup> In a commercial lease context, subordination means the tenant who holds the senior leasehold interest agrees to convert that interest to a junior interest, switching the basic "first in time, first in right" rule, which, would ordinarily mean that in the case of a

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- Id.* Condemnation triggered a change in ownership, and the court held that the tenant was not required to subordinate its leasehold interest and its claim to the condemnation awards because the tenant was not allowed to continue occupying the premises in light of the condemnation. *Id.* Similarly, in a 1992 case, the Georgia Court of Appeals held that because the SNDA conditioned the tenant's subordination of his leasehold interest on the tenant's continued and undisturbed occupancy, condemnation rendered the subordination inoperative because the tenant's occupancy was disturbed. *Raiford v. Dept. of Transp.*, 424 S.E.2d 789 (Ga. App. 1992). Thus, conditioning the validity of the lease's subordination on the tenant's continued enjoyment of the property may render subordination inoperative in the context of condemnation. *Id.* Instead, parties should draft an SNDA that expressly addresses condemnation and delineates priority to condemnation awards in the event of a taking.
4. Courts that have encountered SNDAs have failed to recognize the difference between subordinating the lease to the "lien of the mortgage" versus the "terms and conditions of the mortgage." For example, the Seventh Circuit asserted generally that in an SNDA, "the subordination provision subordinates the lease to the mortgage." *CWCapital Asset Mgmt., LLC v. Chicago Properties, LLC*, 610 F.3d 497, 502 (7th Cir. 2010). In *CWCapital Asset Mgmt.*, the specific language of the underlying SNDA did not inform the Seventh Circuit's understanding of subordination. *Id.* Thus, the court did not recognize any nuances in the SNDA's subordination language that impacted the extent to which the lease was subordinate to the mortgage. *Id.* However, the underlying dispute in *CWCapital Asset Mgmt.* involved the tenant's payment of rent to the lender following its abandonment of the property. *Id.* Additionally, the Ninth Circuit analyzed the effect of two SNDAs in which the tenant agreed to "subordinate its rights [under the lease] to the lien of any mortgage or deed" which should remain "at all times a lien or charge on the Real Property prior and superior to the Lease and all rights of the Lessor and Lessee thereunder." *Goldilocks Corp. of S. California v. Ramkibir Motor Inn Inc.*, 26 F. App'x 693, 695-96 (9th Cir. 2002). When the Ninth Circuit applied the language of the SNDA to the relationship between the tenant's lease and the lender's mortgage, the court simply stated that the two SNDAs rendered the leases "junior" to the deed. *Id.* at 696. Thus, the court failed to acknowledge any particular implications from subordinating "all rights of the Lessor and Lessee" to the mortgage or deed. *Id.*

conflict between the prior lease and the subsequent fee mortgage, the prior document would prevail. Simply stated, subordination by the tenant in our hypothetical means that proceeds will be awarded to the fee mortgagee.<sup>5</sup>

A better approach, and one that could have been accomplished by a single sentence in the SNDA, would have been to explicitly state that the subordination of the ground lease to the mortgage has no impact on the distribution of casualty and condemnation proceeds. Instead, the tenant in the hypothetical described above must either (i) go back to the fee mortgagee and request an amendment to the SNDA to clarify that the tenant (or its leasehold mortgagee) is the party entitled to these proceeds (good luck if the original fee mortgagee was a commercial mortgage-backed securities (“CMBS”) lender and now the fee mortgage is under the control of a servicer) or (ii) purchase a Condemnation and/or Property Damage Loss Insurance Policy to provide supplemental insurance to the leasehold mortgagee.<sup>6</sup> In either case, the tenant in the hypothetical just added significant and avoidable transaction costs to obtain a leasehold mortgage.

- b. Option to Purchase. As noted in the hypothetical above, the tenant under the ground lease has an option to purchase fee simple title to the property for \$1,000,000, but the tenant agreed that the ground lease is subordinate to the \$1,500,000 fee mortgage. Could the tenant force the fee mortgagee to release the fee mortgage by paying \$1,000,000 based on the terms of the ground lease or, since the ground lease is subordinate to the fee mortgage, does that mean that the tenant must pay off the \$1,500,000 fee mortgage in order to exercise the purchase option? Since the \$1,000,000 option price is less than the amount of the fee mortgage, we can most likely assume that the option price is substantially less than the fair market value of the fee estate. Was the proposed leasehold mortgagee relying on the below fair market value option price as part of its collateral package in agreeing to make the leasehold mortgage? Regardless of the answer to that question, the tenant has a big problem to solve.

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5. A subordination agreement is “an agreement by which one who holds an otherwise senior interest agrees to subordinate that interest to a normally lesser interest.” BLACK’S LAW DICTIONARY 68 (7<sup>th</sup> ed. 1999).

6. Based on experience, these policies are only available from one insurance carrier and the minimum premium is \$75,000.

The case law regarding the impact of SNDAs on options to purchase is also scarce, but not surprisingly, the outcome is very similar to the discussion above on casualty and condemnation proceeds. Courts that have considered SNDAs in conjunction with an option to purchase have held that subordination agreements make a tenant's option to purchase subordinate to the mortgage.<sup>7</sup> For example, in *Germain Real Estate Co., LLC*, a lease agreement gave the lessee an option to purchase real property.<sup>8</sup> Soon after the lease was executed, the property was mortgaged.<sup>9</sup> The lessee entered into an SNDA with the lender providing that “[t]he Lease and all terms thereof, including, without limitation, *any options to purchase*, rights of first refusal, rights of set off, and any similar rights, are and shall be subject and subordinate to the Mortgage.”<sup>10</sup> Analyzing this provision, the Western District of Arkansas held that the SNDA amended the purchase options that were originally contemplated in the lease agreement.<sup>11</sup> Specifically, the plain language of the SNDA rendered all options to purchase subordinate to the lender's rights and subject to the lender's final approval.<sup>12</sup> As such, the mortgage holder's interest took preference over the lessee's option to purchase.<sup>13</sup>

What does all this mean to your hypothetical tenant who agreed that the ground lease is subordinate to the fee mortgage? It means that in order to exercise the option to purchase and take title to the property free and clear of the fee mortgage, the tenant must pay off, in full, the fee mortgage. The tenant might be able to make an argument that the ground lessor is responsible for paying any amounts in excess of the \$1,000,000 option price, but that argument probably won't give much comfort to the leasehold mortgagee, who presumably is relying on the below market option price as part of its collateral. Accordingly, the tenant, by not specifically carving out the option to purchase when entering into the SNDA, effectively increased the option price from \$1,000,000 to \$1,500,000.

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7. *Germain Real Estate Co., LLC v. HCH Toyota, LLC*, No. 5:13-CV-05069, 2013 WL 4498789, at \*3 (W.D. Ark. Aug. 21, 2013), *aff'd*, 778 F.3d 692 (8th Cir. 2015); *NRC Golf Course, LLC v. JMR Golf, LLC*, No. 09 CVS 1835, 2010 WL 5557510, at \*6 (N.C. Super. Dec. 29, 2010), *aff'd*, 731 S.E.2d 474 (N.C. App. 2012).
  8. *Germain Real Estate Co., LLC*, 2013 WL 4498789, at \*3.
  9. *Id.* at \*2.
  10. *Id.* at \*4 (emphasis added).
  11. *Id.* at \*7.
  12. *Id.*
  13. *Id.*



- c. Rejection of Non-Disturbance in Bankruptcy. In early 2016, Moody's Investor Service, one of the rating agencies heavily involved in rating CMBS bonds, issued a bulletin (the "**Moody's Bulletin**") pointing out two significant flaws in financing ground leases.<sup>14</sup> One of the two major flaws is subordinate ground leases. As the Moody's Bulletin points out, it should not be necessary to subordinate a ground lease to a fee mortgage. The fee mortgagee is presumably underwriting the rent paid by the tenant under the ground lease and the value of the reversionary interest in the land. Since the tenant under the ground lease (and not the ground lessor) typically pays the cost of constructing improvements, the fee mortgagee's appraisal should not include the value of the improvements, nor should the fee mortgagee have any expectation of receiving loss proceeds attributable to those improvements. As we have seen based on the discussion above, there are many reasons to avoid subordinating a ground lease to a fee mortgage, but the issue raised by the Moody's Bulletin is perhaps the most significant reason to avoid a subordinate ground lease.

The Moody's Bulletin accurately points out that an SNDA (or an NDA, if the subordination provision in the ground lease is self-operative) "may be deemed an executory contract that could be rejected under Code § 365 by the fee lender in its own bankruptcy or declared unenforceable upon the fee lender's insolvency and takeover by the Federal Deposit Insurance Corporation (FDIC) under 12 US Code § 1823(e)."<sup>15</sup> If non-disturbance can be rejected by a lender, particularly when the subordination language in the ground lease is self-operative and the lender provides only an NDA, that means the ground lease is subordinate to the fee mortgage without any non-disturbance which, in most states, means the fee mortgagee can terminate the ground lease following a foreclosure event involving the associated fee mortgage.<sup>16</sup> That would, in turn, result

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14. *The Top Two Ground Lease Financing Flaws: Deficient "New Lease" Clauses and Superior Fee Mortgages*, Structured Finance Report (Moody's Global Credit Research), Jan. 6, 2016.

15. *Id.* at 3 (citing *Kimzey Wash, LLC v. LG Auto Laundry, LP*, 418 SW 3d 291 (Tex. App. 2013) (using 12 US Code § 1823(e) and the D'Oench, Duhme doctrine to declare the SNDA unenforceable)); *see also, In re Butler Services International, Inc.*, No. 09-11914(KJC), 2209 WL 42446431 (Bankr. D. Del. 2009) (holding that an SNDA is an executory contract that may be rejected in a bankruptcy action).

16. *See, e.g.*, 52 C.J.S. *Landlord & Tenant* § 163 (2016).

in the termination of the leasehold mortgage which would convert the leasehold mortgagee into an unsecured lender.

Unfortunately, there is no quick “fix” for this issue and if you’re representing a borrower or lender in a CMBS loan, you have a big problem. At best, your borrower client should expect an increase in the interest rate for the leasehold mortgage loan to compensate the lender for the risk. At worst, your client has a leasehold estate that cannot be financed, at least not by a non-recourse lender.

## NOTES