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COMMERCIAL LEASE NEWSLETTER

**THE EFFECT OF COMMERCIAL FORECLOSURES
ON COMMERCIAL TENANTS:**

**PART 1:
ATTORNTMENT AND NON-DISTURBANCE**

The Real Estate Market of 2010 has been generating a significant increase in commercial foreclosures which is affecting commercial tenants. In fact, commercial foreclosures seem to be on the increase and by all predictions there will be more commercial foreclosures in the coming years as a result of the following:

By all economic indicators and projections, the commercial real estate economy is heading on a course strikingly similar to the path of our residential real estate economy.

A vast oversupply of commercial property was financed and constructed from 2004 through 2008. And like the residential sector, commercial buildings constructed and financed were overvalued, exposing lenders to the extreme risks that come from unsustainable debt levels predicated on high occupancy and unrealistic projections for high rental rates.

Instead, commercial occupancy rates in Florida have dropped dramatically because of increased unemployment as a result of the collapse in residential real estate and the ripples from that. Lee County for instance, is now at the bottom of 100 U.S. Metropolitan areas in unemployment, leading the nation with more than 16% unemployment.

It's a vicious cycle. As vacancies increase, commercial property owners struggle to service mortgage debt, heightening more and more defaults. Nationally, \$814 billion in commercial real estate loans will mature over the next three or four years, yet there are few if any sources for financing and refinancing. And as more loans default, foreclosures result further creating a downward spiral of commercial real estate prices, further putting out of reach any possible refinancing scenarios.

1. **HOW COMMERCIAL FORECLOSURES AFFECT COMMERCIAL TENANTS:**

When a commercial foreclosure is initiated, the lender initiates suit to foreclose out the interest of the owner of the subject property. In case of commercial foreclosures the owner is not only the mortgagor who has defaulted on the payment obligation of the mortgage, but is also the landlord on the property. As Landlord, the owner has contractual rights with all of the existing tenants. In the event of a commercial foreclosure, the commercial lender has the opportunity (depending when the mortgage was put in place and what the terms and conditions of the existing lease contains) to eliminate the interest of the tenant at the commercial property. The impact and effect on the commercial tenant is significant. The Tenant could be exposed to having then leasehold interest foreclosed and losing occupancy especially if a tenant has a below market lease. In a foreclosure action the tenant may also face an uncollectable Landlord to answer for the tenant's damages.

Let's discuss the various scenarios inclusive of attornment and non-disturbance language.

2. **ATTORNMENT LANGUAGE IN A COMMERCIAL LEASE:**

“What the heck does attornment mean?”

In every commercial lease there is generally language in effect as to attornment.

Attornment is defined as follows:

Attornment: In English real property law, is the acknowledgment as to a new landlord by the existing tenant upon the alienation of land.

As used in modern legal transactions, the term “attornment” refers to an acknowledgment of the existence of the relationship of landlord and tenant. A tenant often has duty under the tenant's lease, particularly in commercial leases, to provide an attornment upon request, and is required by a creditor or potential buyer of property from the landlord to establish the nature of existing encumbrances on and income streams flowing from a property, as a element of the due diligence process associated with the transaction.

Attornment is necessary in the event that the commercial owner of the property needs to obtain financing or refinance its mortgage and needs to continue to maintain priority for present or future commercial loans. In such case, the landlord must identify the fact that the tenant agrees to acknowledge the landlord/tenant relationship and subordinate its leasehold interest to the interest of the current or prospective mortgagee (lender).

This satisfies the needs of the commercial lender who wants to have an absolute first priority on the subject property and also empowers the landlord as a mortgagor to finance

and refinance the property. It does have a negative impact on the tenants, especially in situations when the tenant has a very favorable lease.

Here is an example of how attornment can negatively affect a tenant who has a favorable lease: In our example a tenant signs a ten (10) year lease with a favorable lease rate which may in fact be substantially below market. Normally a foreclosing lender may want to keep all commercial tenants in place. However the more favorable the lease is to a tenant, the more incentive the landlord has to eliminate the lease. In such a situation, the tenant's lease (notwithstanding the contractual rights between the tenant and the landlord) can in fact be dislodged if in the future a commercial lender chooses to eliminate that tenant in the event of a foreclosure.

In our example it is a situation in which the commercial lender elects to foreclose out the interest of the landlord/defaulting mortgagor and recognizes the fact that there is an existing lease which creates a negative detriment to the property from a market value. Lenders are keenly aware that the value of the commercial property is predicated on the economic terms of the lease and the strength of the tenant, especially in situations in which the tenant may be a local tenant who has negotiated a below market lease which may have had a negative impact upon the eventual value of the subject property.

If in fact that particular lease has an attornment along with and subordination provision in it, the commercial lender might consider foreclosing out the interest of that existing tenant in the event there is below market rent if the commercial lender believes that in a foreclosure the property would be more valuable without the existing and below market tenant in place.

An example of attornment language without subordination language is:

“Tenant shall at any time and from time to time upon not less than ten (10) days prior notice by Landlord, execute, acknowledge and deliver to Landlord a statement in writing and in form and substance satisfactory to Landlord certifying that this Lease is unmodified and in full force and effect (or if there have been modifications), that the same is in full force and effect as modified and stating the modifications, and the dates to which the basic annual rent, additional rent and other charges have been paid in advance, if any, and stating whether or not to the best knowledge of the Tenant, Landlord is in default in the performance of any covenant, agreement or condition contained in this Lease and, if so, specifying each such default of which Tenant may have knowledge. Any such statement delivered pursuant to this paragraph may be relied upon by any prospective purchaser of the fee of the Building or the Project, or any mortgagee, ground lessor or other like encumbrance thereof or any assignee of any such encumbrances upon the Building or Project.

If any Superior Lessor or Superior Mortgagee shall succeed to the rights of Landlord hereunder, whether through possession or foreclosure action or deliver of a new lease or deed, then, at the request of such party (hereinafter referred to as “Successor Landlord”), Tenant shall attorn to and recognize each Successor Landlord as Tenant's landlord under

this Lease and shall promptly execute and deliver any instrument such Successor Landlord may reasonably request to evidence such attornment. Upon such attornment, this Lease shall continue in full force and effect as a direct lease between Successor Landlord and Tenant upon all the terms, conditions, and covenants as set forth in this Lease except that the Successor Landlord shall not: (1) be liable for any previous act or omission of Landlord under this Lease; (2) be subject to any offset, not expressly provided for in this Lease, which theretofore shall have accrued to Tenant against Landlord; or (3) be bound by any previous modification of this Lease or by any previous prepayment, unless such modification or prepayment shall have been previously approved in writing by such Successor Landlord. The requirements of Tenant hereunder to attorn to and recognize a successor Landlord are subject to Tenant being provided with quiet enjoyment of the subject premises and without disturbance of any rights afforded to Tenant under this Lease agreement.”

If a lease contains a subordination provision, subordinating the right of the commercial tenant to superior mortgages, then the tenant could have its leasehold interest foreclosed. A commercial tenant has to be keenly aware in its negotiations that although it has contractual rights identified as far as length of term, base rent and other lease terms, in a situation in which a tenant allows for an attornment together with subordination paragraph to be inserted into the lease, the tenant’s position will be inferior to the lender who is in place at the time that the mortgage was put in place. They are also potentially inferior to even future lenders who can rely upon the attornment and subordination language to take priority over the tenant’s position.

Next Month: Non-Disturbance Language