ACREL News

President's Message

Welcome to New Fellows

We are delighted to welcome to ACREL our 2011 class of new Fellows. The link to the complete list of new Fellows is on the website, http://www.acrel.org/Private/DrawCommitteeContent.aspx?Action=CommitteeContent&CommitteeContentID=1963

Please be sure to look for the new Fellows at the Annual Meeting in Philadelphia and help to ease their orientation and integration at ACREL.

For any new Fellow (or seasoned Fellow, for that matter) who has not joined a substantive law committee, an appointment is a telephone call or email away. Don't be shy – give a committee or two a try. There is no obligation and no waiting! Your Directory includes a list of the committees.

ACREL Logo

As announced in May, ACREL has adopted a policy allowing Fellows to use the ACREL Logo. (You may use this link to read the full policy: http://www.acrel.org/Private/DrawCommitteeContent.aspx?Action=CommitteeContent&CommitteeContentID=1958)

We adopted this policy to provide to Fellows more value for their membership in ACREL and as part of our outreach to make the broader legal and business community aware of ACREL, its Fellows and its mission. We do hope that all Fellows will take advantage of the right to use the logo. Please let us know about any feedback you receive when you do.

Wanted: New ACREL Fellows

Although our formal nomination process for new ACREL Fellows will kick off in December, it's not too soon to start thinking about your nominations for the Class of 2012. New forms will be posted in the fall for you to use in making nominations. If you have questions about our admissions criteria, you will find the guidelines in the Directory and on the website helpful, and our Member Development Committee is also available to you. The chair is Aasia Mustakeem, and committee members can be found on the Member Development Committee page on the website via this link: http://www.acrel.org/Private/DrawCommittees.aspx?Action=ShowOneCommittee&CommitteeID=MDC.

Looking Ahead to Meetings in Philadelphia, Las Vegas and Chicago

The Program Committee, under the leadership of Rob Freedman, is putting the finishing touches on the agenda for the Annual Meeting,

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which will be October 20 - 23 in Philadelphia. Dick Goldberg and Julian Rackow are polling Fellows in the Philadelphia area for ideas on restaurants and tour venues. Don't delay in making your plans to attend the Annual Meeting!

The Program Committee of ACREL never has a down time. Larry Shulman is leading the planning for the 2012 meetings in Las Vegas and Chicago. If you have suggestions for the programs, please send them on to Larry ASAP.

Local ACREL Meetings

ACREL Fellows have demonstrated the collegiality we all value by attending local meetings this year. So far, these local meetings have occurred, each with great attendance:

• Lunch March 2 in Boston, hosted by Paul McNamara and organized by Paul and Kathy Murphy.

• Cocktail reception April 6 in Atlanta, hosted by Mason Stephenson and his firm, King and Spaulding and organized by Jonathan Shils, Wayne Hyatt and Jo Anne Stubblefield.

• Cocktail reception April 13 in Philadelphia, hosted by Dick Goldberg and his firm, Ballard Spahr, and organized by Dick.

STAFF BOX

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Editor
Jill H. Pace
Executive Director

• Lunch April 20 in New Orleans, organized by Scott Willis.

• Cocktails April 28 at the ABA Real Property Trusts and Estates Section Seminar in Washington, DC. Kevin Shepherd hosted this event.

• Lunch May 5 in Columbus organized by Ken Kuehnle. This lunch was scheduled to coordinate with the Ohio State Bar Association annual meeting.

We have more meetings scheduled:

• Cocktail reception in September in Atlanta, hosted by Andy Kaus. (The folks in Atlanta enjoyed the April event so much that another was quickly scheduled.)

• Lunch June 13 in New York City, hosted by Don Siskind and organized by Joshua Stein, Don Siskind and Angela Christy

• Lunch June 20 in Cleveland, organized by Dianne Coscarelli

• Seattle event in June, organized by Gordon Tanner. Details are being finalized.

• Houston event in early stages of planning. Marilyn Maloney is organizing.

• Dallas event is being organized by Ed Peterson & John Nolan.

• San Antonio event is being organized by Steve Waters.

• Chicago event is being organized by Alvin Katz.

• Los Angeles event is being organized by Ira Waldman.

Organizing a meeting involves minimal time and effort: pick a date, plan the format and send out email invitations. Some meetings have been sponsored by hosting Fellows or their firms, while others are paid as you go, with costs split by those attending.

The Orientation and Integration Committee is standing by to provide tips and make it as easy as possible for the volunteers to organize. If you are interested in organizing a meeting, please contact Ken Jacobson, Kathy Murphy or Trev Peterson of the Orientation and Integration Committee, Board Liaison Angela Christy, or Jill Pace at the ACREL office. If

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you are in one of the cities listed above for which a meeting is being planned, you also may reach out to the organizer to offer your assistance.

In any event, please be sure to advise Jill Pace and me as soon as you have a date set, as I have been attending as many of the meetings as I can manage.

ACREL Nominating Committee

Under the leadership of Past President Kevin Shepherd, the Nominating Committee has begun its work for 2011. The Committee members include Phil Weller, Janice Carpi, Rod Clement, Jay Neveloff, Joan Story and Steve Waters. The Committee seeks input as it develops its recommendations for ACREL leaderships roles, including President-Elect, Secretary, Treasurer and several Board of Governors slots. Please do contact any member of the Committee if you would like to discuss potential nominees.

Pilot Project in Outreach to Law Schools

At the suggestion of Mike Rubin, we invited Larry Ponoroff, dean of the University of Arizona Law School at Tucson, to attend our Thursday night reception in Tucson. We also invited participation by real estate law faculty from the University of Arizona Law School at Tucson at our Tucson program. Professor Carol Rose attended the Thursday afternoon program. We had very good feedback on this, from the visitors and the Law School Teaching Task Force, so we plan to continue experimenting for the Philadelphia meeting. The goal is to increase familiarity among law schools, their real estate faculty and law students about ACREL and the developments in real estate law that we find exciting. The Law School Teaching Working Group is developing recommendations on this pilot project.

Looking for a Publishing Opportunity?

If you have an idea for an article on a real estate or practice topic, please keep in mind the ACREL Newsletter. This is a great opportunity to re-cycle a piece you may have prepared for a seminar or client bulletin. Light hearted pieces are welcome, as well as more formal articles. You also may submit news items about another Fellow or yourself.

In addition, the BNA Real Estate Law and Industry Report welcomes submission of articles by ACREL Fellows. If you'd like to submit to BNA, please direct your submission to Richard Cowden at RCowden@bna.com, and be sure to emphasize that you are an ACREL Fellow. Kindly cc Jill Pace and me as well.

Update on Title Insurance Survey on International Deals

Thanks to all who participated in the survey circulated by the International Title Assurance Subcommittee regarding international real estate and title insurance. The results are being analyzed and you will hear more about this in the future.

Looking for a Volunteer Opportunity?

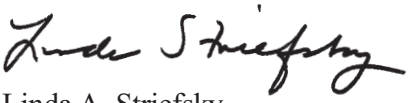
If you'd like to join an ACREL substantive law committee or are interested in an administrative committee, please do let me know. ACREL has lots of volunteer slots, so don't be shy!

The ACREL Suggestion Box

If you have questions, comments or suggestions on anything regarding ACREL, please do get in touch with me. Your thoughts are always very welcome.

I hope you all enjoy the summer months, and I look forward to seeing you in October in Philadelphia!

Best regards,



Linda A. Striefsky
President

What to Expect When A Receiver Takes Over A Troubled Property

by Andrew L. Herz and Joshua Stein.[1]

Early in any judicial foreclosure action, the lender that started the foreclosure will often ask the court to appoint a receiver to take control of the property away from the borrower. Though this article primarily addresses receiverships in New York, where foreclosure actions typically take several years, many of these principles apply in other jurisdictions as well.

Appointment of a receiver represents a crucial step in the foreclosure process. It immediately changes the dynamics and the relationship between borrower and lender. Before the era of nonrecourse carveouts for voluntary bankruptcies, appointment of a receiver often drove a borrower to file bankruptcy almost immediately, in the hope that this might keep the lender and the receiver at bay.

Because a receivership typically lasts as long as a foreclosure, it can potentially continue for several years, as borrower and lender try to resolve their claims about the property (or try to delay the resolution of those claims). While the foreclosure action wends its way through the courts, the presence of a receiver is intended to protect the lender from the risk that the borrower will mismanage or steal from the property. The receivership is also intended to assure that the property does not deteriorate under the control of a distracted and penniless borrower.

Any well-drafted mortgage usually states that the holder of the mortgage can have a receiver appointed if the lender starts a foreclosure action. At least in New York, the lender can do that fairly easily. Assuming the mortgage has the right language in it, a New York borrower isn't even entitled to notice of the motion to appoint a receiver and the lender's right to appoint a receiver doesn't depend on whether the loan is "underwater." It's enough for the loan to be in default.

A foreclosure court in New York generally must choose the receiver from a list of candidates who have qualified to become a receiver and are not otherwise disqualified under the Rules of the Chief Judge. Other states may have similar limits on the court's choices in appointing a receiver. In any large and complicated foreclosure action, the judge will often ask the lender's counsel to nominate potential receivers.

For a borrower, appointment of a receiver doesn't need to mean the end of the world. Conversely, a lender shouldn't assume that appointment of a receiver turns the lender into the immediate king of its collateral, entitling it to act as if it owned the property. Indeed, a principal reason a lender wants to see a receiver in place is to protect the lender from liability that the lender could face if it actually took possession of the property itself.

The receiver is appointed by and works for the court, with the goal of preserving the property for the benefit of the parties, trying to assure that whoever ultimately wins control or ownership of the property will get something worth controlling or owning. The receiver does not take orders from the lender, but may seek suggestions from both parties. To the extent that the receiver needs the lender to advance funds to preserve the property, though, the receiver will pay particularly close attention to the lender's suggestions.

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1 Andrew L. Herz is a partner of Patterson, Belknap, Webb & Tyler LLP (www.pbwt.com). Joshua Stein operates an independent law practice, Joshua Stein PLLC (www.joshuastein.com). Both authors are qualified to act as receivers in New York State.

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In many ways, arrival of a receiver is much like a transfer of the property – or at least its management -- to a new buyer or manager, except that it typically occurs without the cooperation of the borrower, as the transferor. Instead, it occurs by court order, often without prior notice and on a very compressed and sometimes chaotic schedule.

Before the receiver can actually step in, the receiver will need to obtain a bond and file an oath, both quickly accomplished by any knowledgeable receiver. The receiver will also need to obtain a new taxpayer identification number and open new bank accounts into which all receivership funds will be deposited.

The receiver often will want to document the property's physical condition at the commencement of the receivership by walking through, preferably with a camera, perhaps accompanied by advisers on construction issues and safety issues.

The receiver will need to consider just how to manage and preserve the property during the receivership. This will typically require the receiver to retain its own counsel, hire a property management company (though its responsibilities will vary widely depending on the type and status of the property), and often hire a security company.

The existing insurance program should be extended to cover the receiver, typically a much easier and more cost effective process than replacing the existing insurance. The receiver will, however, need to worry about any pending or upcoming cancellation of insurance that might result from changes or other issues at the property.

In general, when a property goes into foreclosure, something is seriously wrong. The easiest case from a receiver's perspective consists of a perfectly respectable property, such as a fully leased and operating office building or shopping mall, that has just been overleveraged and therefore cannot cover debt service. From the receiver's perspective, the inability to pay debt service is not a problem – debt service is the one expense that the receiver can leave unpaid, as the foreclosure process itself will resolve the debt on the property.

At the other end of the spectrum lies a property that is either under construction but unfinished, or finished but entirely vacant. Because the receiver acts in the first instance as a "receiver of the rents," if no rents exist or the existing rents won't cover expenses, the receiver faces a very serious problem. In such a case, the receiver, before taking on responsibility for the property, needs to figure out, as well as it can, how much cash the receiver will need.

The receiver will consider not just monthly shortfalls to pay operating expenses, but also deposits with vendors and utility companies and payment of the receiver's expenses and commissions. For a property that is vacant, or that has incomplete construction, the receiver may need to worry about immediate repairs that must be undertaken -- including remediation of mold and safeguarding the property. The receiver will also need to identify alternatives to remediate mold or other dangerous conditions to demonstrate that it has addressed any problem in a thoughtful manner.

Even if the property produces no income, the receiver will still need some source of funds just to try to preserve the property. For any receiver, the lender will typically represent the only likely source of funds. Most mortgage documents do allow the lender to spend money to protect its collateral, and then recover those expenses from the borrower as part of the borrower's secured obligation. Once a receiver is in place,

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those expenses will run through the receiver, with the lender adding them to what the borrower owes from a lender.

A receiver will want to try to assess what it will cost to run the property and will want a clear understanding about the lender's commitment to cover any property-related costs if property revenues won't cover them. If the holder of the mortgage loan is not an institutional lender – for example, a "loan to own" investor – the receiver may insist on a reserve for expenses, perhaps on an "evergreen" basis covering projected expenses for some reasonable time. These expenses could well include provision for the receiver's fees and expenses.

Often, a potential receiver -- or the lender appointing the receiver -- will want to have a full and frank discussion about the receiver's fees. Normally, in New York, the court sets a receiver's commission, which cannot exceed five per cent of the funds that pass through the receiver's hands.

If the property generates a great deal of cash, the lender will generally negotiate a commission at a lower percentage rate and will seek to have the court bless that agreement early in the proceedings. At the other end of the spectrum, a vacant property generates no revenue but may require a great deal of effort and decisionmaking by the receiver, especially during any construction. In such instances it is not uncommon to compensate the receiver at an agreed hourly rate, but the receiver and the lender should seek early court approval of the fees.

Over time, as the receiver becomes more familiar with property operations, the receiver should develop a budgeting process to prevent surprises and fine-tune the amount of any reserve account.

Any prospective receiver will typically raise and try to resolve any operational or financial concerns before the receiver's appointment becomes effective. In that process, the receiver will also try to become familiar with the property and prepare to take control as soon as appointed. That process will vary widely as properties can vary. A single article of reasonable length cannot do justice to every possibility.

The receiver will probably obtain an updated title search and a litigation search. Particularly for a construction project, the receiver will probably want an updated violations search. The receiver might have an expeditor pay an early visit to the building department to understand the status of construction and permits; whether any serious issues exist on the job; and which permits will need to be reissued or amended once the receiver comes into the picture.

The court's order defines what the receiver can and cannot do. Thus, both a lender and a prospective receiver will want to review the order carefully, to try to minimize any need for amendments once the receiver starts work. The receiver will want, among other things, to minimize the need to obtain approvals for minor actions or decisions from the lender or, even worse, from the court.

Any receiver acts as an officer of the court. Thus, any receiver should operate with as much transparency as possible. The more that the receiver discloses to all parties, the better. The receiver may want to set up a computerized list-serv to assure that each interested party receives as much information as possible.

The receiver has no special duty to any party – only to the court and the property – and nothing is confidential. Borrower, lender, and their counsel must remember this fact when communicating with the receiver and filter their communications accordingly.

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If the receiver sends all parties copies of all contracts, bids for services, bills, bank statements, and financial reports and invites comment, the receiver sends an important message: the receiver is really trying to keep everyone advised of developments. That doesn't mean the receiver needs to ask anyone's permission, as long as the receiver complies with the order of appointment. Even so, early and frequent communication should estop parties from complaining later on. A prudent receiver will use separate stationery to indicate his status as receiver.

The receiver will need to operate, or at least maintain, the property – if possible – in a way that does not require much court involvement because each trip to the courthouse will produce expense and delay. Thus, within reason, any lender having a receiver appointed will want the receiver to have fairly wide authority, within broad constraints.

As its first responsibility, any receiver will identify and gather the assets for which it is responsible. Taking possession of a building is usually only the first step. With it should come all related books and records, permits, insurance policies, lease security deposits, letters of credit, personal property, contracts, keys, and anything else ancillary to the property. In some cases, depending on the structure of the lender's collateral, the receiver will take control of property-related bank accounts.

The receiver will typically start this process by giving written notice to the borrower's counsel, with a copy of the order of appointment. At the same time, the receiver will serve any tenants with notice of the receiver's existence, again with a copy of the order of appointment, and will direct the tenants to pay their rent to the receiver. If the borrower does not deliver keys to the receiver, the receiver may need to enlist a locksmith to take physical possession of the property – and will then need to maintain security starting immediately.

For property under construction or substantial renovation, the receiver's task becomes more complicated. The first question, of course, is asking whether the receiver even has the power or authority to continue construction – or is simply responsible for preserving the property. The answer to that question depends on the receiver's order of appointment.

To begin to understand the questions the receiver needs to ask itself, the receiver first needs to know who is already working on the job and under what terms. This will require copies of all contracts. A newly appointed receiver will want to see payment records and lien waivers to understand where the project stands financially.

The receiver must quickly assess which existing contractors and professionals it wants to keep. To replace the project architect or structural engineer during construction, for example, will probably leave the project in serious limbo.

In many cases, the lender will have obtained letters from the project architect and perhaps other major service providers, in which they agreed to keep working if the lender were to foreclose and take over the project. But does the letter say anything about what happens if a receiver is appointed?

Often, no. In the real world, though, regardless of what the loan closing documents say, any project architect and almost all other professionals would like to finish any projects that they start. As long as they keep getting paid, they will most likely stay on.

Paid for what? Any receiver will typically not pay for prior work, but only for work going forward. In most cases, architects and service providers will stay on the job on that basis, even if not contractually obligated to do so.

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Contractors and subcontractors raise larger issues. Certain trades -- such as plumbers and electricians -- whose signoffs are needed to obtain governmental approvals can be very problematic. So too will be any roofing subcontractor, whose 20-year warranty may vanish if the subcontractor stops work and doesn't finish the job.

Usually contractors and subcontractors first want to be paid for work they have already done, before talking about future work. A receiver, however, has no obligation to pay for past work, and any liens arising from past work will usually be subordinate to the mortgage being foreclosed. Indeed, if the receiver pays for prior work without appropriate approvals, the receiver could face liability.

As a practical matter, contractors whose work is finished will not be paid. Contractors who aren't finished but will compromise and settle their claims will be paid and kept on the job. Those who won't will be replaced.

Before the receiver can resume any construction, the receiver must understand the status of permits and approvals for the project. In most cases, some permits and approvals will be in progress and open, and the receiver will want to take control of that process. This will usually require reissuing permits and applications in the receiver's name – a process that the receiver will ideally have already understood at the moment of appointment. If the building has a temporary certificate of occupancy, one of the receiver's first questions will relate to the expiration date of the TCO. Its renewal may become one of the receiver's first tasks.

Depending on the nature and status of the property, leasing may raise at least as many concerns as construction for the receiver, the lender, and the borrower.

If the foreclosing lender wants to see new leases – or no leases – get signed, then the order of appointment should grant or deny the receiver authority to enter into leases. In most cases, receivers have very little authority to enter into leases, at least for longer than a year or two, because of concern that long-term leases could reduce the appeal of the property to possible bidders at a foreclosure sale, and thus reduce the selling price of the property. On the other hand, leases that last no longer than the foreclosure proceeding can create revenue without chilling bidders.

Leases for more than two years usually require court approval. If the property consists of an office building, the receiver may want to sign ordinary leases. These may make sense for the property, but it usually won't be just the receiver's decision. The receiver will need court approval, which will require the receiver to make a convincing case. Toward that end, the receiver may enter into a lease that expressly says it is subject to court approval. That approval process will give borrower and lender an opportunity to have their views heard and should protect the receiver against claims that it acted imprudently.

Leases costs money. Usually the receiver as landlord will need to pay for (a) the costs of any base building work needed for the tenant's premises, (b) a tenant improvement allowance and (c) brokerage commissions. To the extent that the receiver is fortunate enough to have these funds on hand, he is indeed in an enviable position. Usually this is not the case – if it were the case, the property probably wouldn't be in foreclosure – so the receiver must either seek the funds from the foreclosing lender or seek to minimize them by having the tenant, for example, assume responsibility for the brokerage expenses or agree to forgo a tenant improvement allowance. To the extent that the tenant assumes these responsibilities, the tenant will pay less rent.

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The fact that the signed lease will be submitted to the court for approval can give the receiver a powerful negotiating tool. The receiver can take the position that the lease must be at or above market in order to get approval, and the receiver can take a hard line in negotiations. To the extent any party objects to the lease terms, the receiver may be able to push the rent up further.

Who pays ordinary expenses of the property? If the property produces rental income, the receiver will collect it (i.e., "receive" the income; hence the title "receiver"). The receiver will use that rent to pay expenses, typically holding any remaining net operating income pending the outcome of the proceeding. The receiver won't pay the lender's debt service, absent agreement between the parties or a court order.

An important element of any receivership consists of careful recordkeeping and bookkeeping. All communications and agreements should be carefully and systematically filed so that they may be produced when needed. Every cent that comes into the receiver's hands must be accounted for and every expenditure fully documented. If a property manager has been engaged, its approval of all expenditures should be documented.

The receiver will also use some of the property income to pay management fees and the receiver's own fees – perhaps monthly or quarterly but, in each case, subject to court approval.

In entering into agreements, the receiver must limit its liability and make clear that it has no personal liability. Just signing as the receiver will not necessarily suffice. A prudent receiver will include in every contract that it signs a disclaimer much like this: "The temporary receiver shall have no personal liability under this Agreement. In the event of any actual or claimed breach of this Agreement by the temporary receiver, recourse may be had only against the receivership assets. No personal assets of the temporary receiver shall be subject to claim or levy."

Although no borrower is ever delighted to see a receiver enter the picture, the borrower can respond in various ways. The borrower's choices at the beginning of the process will help determine just how painful the receivership will turn out to be for the borrower.

If a borrower can demonstrate competence, reliability, and knowledge, the receiver may have greater confidence in the borrower and greater willingness to accept the borrower's suggestions and ideas about how the receiver should oversee the property. In contrast, if a borrower decides to "fight the receiver," that will certainly produce more visits to court and more expense – but it will not get rid of the receiver nor enhance the borrower's dealings with the receiver.

Serving as a receiver can be a very satisfying experience. The receiver has the opportunity to come into a troubled situation and make it better for all involved. Even maintaining the status quo for a significant property where the parties are at war can be a Herculean task. If the receiver can keep in mind that its task is a simple one – just to do the best that he or she can for the benefit of the property, while keeping everyone fully informed – the receiver can look back (and tell the court) that the receiver did his or her job honestly, fairly, transparently, and with a goal of not unfairly prejudicing any party. ■

Call for Volunteers

Fellows interested in writing for and/or speaking at ACREL programs are urged to contact Larry Shulman, lshulman@shulmanrogers.com.

Subordination Without Nondisturbance: A One-Sided Marriage

by Jeffrey Hugh Newman, Sills Cummis & Gross P.C., Newark, NJ

If love and marriage go together like a horse and carriage, surely a demand for subordination[1] should be followed by a request for nondisturbance. In effect, subordination (and attornment) by a tenant is the tenant's vow to remain a tenant through good times or bad (including foreclosure and its aftermath), for better or for worse; but, if the landlord does not give the tenant nondisturbance protection, the landlord does not reciprocate the vow. Naked subordination (subordination without nondisturbance) allows any mortgagee who may succeed to the landlord's position by foreclosure to accept or reject the tenant (i.e., honor or terminate the tenant's lease) by virtue of the tenant's subordinate position.[2] History has shown that the previously unlikely scenario of a landlord default followed by a lender takeover is not only possible but no longer a rarity. As a result, many tenants are now vulnerable to successors in interest who may either terminate their leaseholds or continue them after weakening many leasehold rights. Accordingly, tenants must increase their focus on subordination provisions in order to ameliorate the harsh potential results of naked subordination.

The Subordination Clause

A subordination clause (as generally found in a landlord's form lease or in a separate form subordination agreement prepared by the landlord's mortgagee) makes all tenants' rights junior, subject, and subordinate in all respects. Classically, the interest that the clause makes superior to a tenant is that of a subsequent lender/investor whose interest is evidenced by a mortgage or deed, depending on the jurisdiction.[3] The subordination clause elevates all mortgages that, because they were executed after the tenant's lease, would otherwise be junior to the tenant's lease interests.[4] The mortgages have been made contractually senior.

Landlords seek to subordinate tenants' leasehold interests because they know that lenders will require such subordination. Before they agree to a financing, mortgagees seek that all of the borrower/landlord's tenants execute subordination agreements. If some of the tenants are not obligated to do so and, in fact, refuse, the landlord finds it significantly more difficult (certainly costlier and, perhaps, impossible) to effect a financing or refinancing. By requiring tenant subordination, lenders are, in effect, granting themselves the right to terminate a tenant's lease following foreclosure. Thus, they assure themselves a freer hand to remolecularize a distressed property. (The mortgagee, at its option, can also elect to honor the tenant's lease, thereby requiring the tenant to remain in place, to honor its obligation to attorn to

1 For purposes of this article, it is assumed that the request (demand) for subordination is being made by a landlord (currently in lease negotiations with a prospective tenant) who intends to effect a financing either contemporaneously or in the near future to fund the current transaction or may wish to effect a financing in the distant future for perhaps expansion or eventual refinancing. References to nondisturbance throughout this article include recognition.

2 A tenant will be subordinate to a lender who "takes over the property" by foreclosure either because the lender's mortgage was recorded prior to the execution of the tenant's lease (whether or not recorded), or because the tenant, whose lease was prior in time to the recordation of the lender's mortgage, executed a subordination agreement.

3 In this article, all interests superior or desiring to become superior to the tenant's lease are referred to as a mortgage.

4 The mortgages become superior pursuant to the subordination agreement even if the lease or a memorandum thereof is recorded (just as a deed is recorded) prior to the recordation of the mortgage.

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the mortgagee, as if nothing had occurred.)[5] However, stronger tenants know that the mortgagee requirement of absolute subordination, without any nondisturbance protection, is not ironclad.

Nondisturbance Protection

Because naked subordination leaves the tenant at the whim of the superior interest, tenant negotiators must fight hard to obtain some nondisturbance protection. Lack of nondisturbance protection exposes the tenant to the devastating result of lease termination. Although this eventuality would hurt any tenant, retail commercial tenants are particularly devastated by unexpected terminations because their locational-operational goodwill is wiped out unless they find a sufficiently proximate new location to which to transfer their premises.

Tenants who seek nondisturbance protection generally are successful because landlords recognize that tenants need and mortgagees will provide at least some protection. An existing mortgagee interest is already senior to the rights of a subsequent tenant; that mortgagee does not need the subordination clause in the leases of subsequent tenants and has absolutely no need or reason to offer any protection to those tenants. In that circumstance, it is the tenant who must seek nondisturbance protection. Hence, tenants should require landlords to undertake good-faith efforts to obtain nondisturbance protection from existing mortgagees. In fact, the strongest of tenants will demand nondisturbance and recognition protection from current mortgagees as a condition to entering into leases with landlords whose properties are thus encumbered. Future mortgagees, however, need and demand subordination from existing tenants, and most tenants generally can obtain at least limited nondisturbance from these lenders.

Nondisturbance protection comes in various shapes and sizes. Often, after long negotiations the nondisturbance language that a lender inserts into a subordination agreement with the tenant provides far less protection than the tenant needs. Often the best language that the tenant can extract from the lender protects only the tenant's possessory rights. But the tenant requires much more than a mortgagee's agreement not to disturb the peaceful and quiet possession of the premises. A lease confers not only possession but an additional bundle of rights upon the tenant, and it places a bundle of obligations upon the landlord. Consequently, a nondisturbance provision in a lease that fully protects the tenant (or the nondisturbance language that must be inserted into a subordination agreement) must secure both the tenant's bundle of rights and the tenant's ability to enforce the bundle of obligations that the landlord has undertaken.

The Timing of Rights and Obligations

An important subject of nondisturbance rights negotiations concerns when they become operative or effective. In the usual case, the superior mortgage document (or documents related to it) confers rights upon the mortgagee that are inconsistent with or modify the tenant's rights under the lease. Thus, the tenant loses certain rights as soon as the subordination agreement is executed regardless of whether a foreclosure or similar event ultimately occurs. However, although the tenant subordinates its rights in the present, the nondisturbance provisions and

5 Subordination agreements specifically provide for a tenant to attorn to the lender such that the lender can be assured that, in the event of foreclosure, if the lender so elects the tenant will remain a tenant and acknowledge the lender as its new landlord.

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protections often become effective only upon lender takeover, a circumstance that may never occur. The divergence in timing creates the potential for devastating consequences.

For example, a damage and destruction clause in a lease may require the landlord in all events to rebuild the leased premises. The damage and destruction clause in a mortgage generally permits the mortgagee, at its election, to apply the insurance proceeds to reduce the principal balance of the mortgage; if the mortgagee chooses to do so, the landlord will at least be significantly delayed in rebuilding the leased premises. Because the lease becomes subordinate to the mortgage upon execution of the subordination agreement, the mortgage's damage and destruction clause immediately governs, unless the nondisturbance language specifically protects the tenant.

The tenant does not need a complex protective clause. Fairly concise, quick-fix language requires the mortgagee to "immediately honor all of the tenant's rights under the lease as well as to honor all the landlord's obligations under the lease." The parties could then specify in detail those tenant rights or landlord obligations that are inconsistent with the mortgage. The agreement should indicate that for those rights and obligations, the provisions of the lease should govern and should prevail over those of the mortgage. Because inconsistencies virtually always exist between the lease's damage and destruction clauses (and condemnation clauses) and those of the mortgage, the mortgagee's representation that it will honor all of the obligations of the landlord probably should be supplemented by the phrase "including, but not limited to, the use of insurance and condemnation proceeds."

Thus, the tenant has obtained immediate protection from inconsistencies between the lease and the mortgage that could impair or wipe out important tenant benefits, as well as the protections that it will need if and when the mortgagee forecloses on the landlord's interest.

Mortgagee Obligations And Exceptions

Just as tenants with the requisite negotiating leverage protect themselves from the potentially harsh effects of a naked subordination agreement by assuring themselves that mortgagees will (among other things) recognize[6] and assume the landlord's obligations under the lease, mortgagees seek to avoid agreeing to assume certain obligations, particularly old repair-maintenance obligations that the landlord has neglected and that would usually become the mortgagee's obligation in the event of foreclosure. It is virtually axiomatic that when a mortgagee takes possession from a defaulting borrower-landlord, the mortgagee encounters the harsh reality of a neglected piece of real estate.

Quite possibly, the tenant will have also declared the landlord in default because the landlord has failed to honor its repair-maintenance obligations under the lease. In fact, the tenant may have exercised a self-help remedy and expended its own funds for maintenance or repairs that cured the landlord's defaults. Thus, in a common scenario, two innocent parties, the tenant and the mortgagee (who has now become successor landlord), must determine who bears responsibility for the sins (either of commission or omission) of the prior landlord.

6 The nondisturbance elements discussed above, in effect, require the mortgagee to "recognize" the tenant's leasehold and its rights thereunder.

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Subordination Without Nondisturbance:...

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Landlord's Defaulted Obligations

Not surprisingly, mortgagees seek exculpation from all the past obligations that devolve on them following foreclosure because they automatically assume the prior landlord's responsibilities (fulfilled and unfulfilled) under the lease.

Over the years, mortgagees have developed a litany of exemptions to pursue during negotiations. Although many are reasonable from a tenant's perspective, others appear to unfairly favor the mortgagee. In general, mortgagee/successor landlords seek exculpation from any acts or omissions of the prior landlord and refuse to be subject to any offsets or defenses that the tenant was (and is) entitled to assert against the prior landlord. Although this clean-chalkboard approach is asserted as merely removing the mortgagee from participation in disputed landlord-tenant obligations, in effect it simply favors the innocent mortgagee over the innocent tenant in the determination of who must cure or be responsible for curing the prior landlord's defaults.

Both mortgagee and tenant negotiators can wax eloquent about their respective entitlement to exoneration. Because valid arguments exist on behalf of both parties, compromise must be sought.

Tenant negotiators attempt to modify a mortgagee's request for complete exemption from the landlord's defaulted obligations by keying exemptions to the mortgagee's acts before the mortgagee took over the property but after the tenant has notified the lender of the landlord-mortgagor's default. For example, most subordination agreements require the tenant to notify the mortgagee of all landlord defaults, to provide the mortgagee with ample opportunity to cure, and to further notify the mortgagee before it uses any self-help measures available under its lease to cure the default. If the tenant has fulfilled its notification obligations, it can make the following argument. The mortgagee should not be entitled to ignore a mortgagor default about which it has received multiple notifications from the tenant and that it has had a reasonable opportunity to cure. Because the mortgagee has not availed itself of the opportunity to cure, the tenant can argue its "greater innocence" and demand that the mortgagee assume postforeclosure responsibility for the prior landlord's defaults. On the other hand, a mortgagee may assert that certain cures cannot easily be effected and may even jeopardize the validity or value of the mortgagee's lien.

Perhaps except in special situations in which a cure was impracticable or threatened lien validity, if the tenant in fact met all of the mortgagee's notice preconditions, it has a strong argument that the mortgagee should become liable for such defaults when it takes over the property. The parties could agree upon a cost-sharing formula to compromise this issue. A quick-fix solution might call for a 50-50 sharing of the costs of many obligations with mortgagee exceptions related to special circumstances.

Yet, given their bargaining leverage, most mortgagees simply will not compromise in the subordination agreement on the issue of uncured landlord obligations. However, the equities certainly justify tenants' raising the issues. When mortgagees retain full exoneration, they, in effect, pass on to the tenant the costs of properly maintaining the mortgagee's collateral.

Tenant negotiators sometimes argue that some or all of the burden of postforeclosure cure of preforeclosure landlord defaults should fall on the lender because the lender analyzed the entire loan transaction on a risk of default

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basis while the tenant analyzed its lease aspect of the transaction on an operating profit basis. They argue that lenders have deeper pockets than tenants and are better equipped to expend due-diligence dollars to analyze the borrower's and project's creditworthiness. Ultimately, allocation of the costs of postforeclosure cures is determined by complex factors that may have little to do with logical argument.

The Problem of Prepaid Rent

After the foreclosure, the lender may discover that tenants have made extensive prepayment of rents, the proceeds of which never found their way to mortgage and other required payments. Therefore, another classic exculpation sought by mortgagees is protection against such prepayments of basic rent and additional rent. The lender wants a situation in which the tenant is deemed to have made such prepayments at its sole risk, and if the prepayment was misapplied, the tenant after foreclosure must pay to the mortgagee the same obligation when it actually becomes due. While such a clause relating to basic rent has merit, it is inappropriate and unfair to make a tenant liable to a mortgagee for tax or other additional rent payments that the tenant has been required to make under the terms of the lease, on a multimonth basis. Accordingly, the mortgagee is entitled to prepayment protection only in cases of voluntary, as opposed to required, prepayments of additional rent.

Other Exemptions of Mortgagee Obligations

Mortgagees often insert provisions into subordination agreements that declare any amendment to the tenant's lease to be void and of no effect unless the mortgagee consented to the amendment. Such a clause is probably unnecessary (it should be subordinate to the previously consummated subordination agreement); it also could be unfair because it prevents the landlord and tenant from readily making appropriate lease modifications. Mortgagees want these provisions in order to prevent collusive arrangements between the landlord and tenant that impair the mortgagee's collateral. The parties must balance this protection against the need of landlord and tenant to be able to adjust the lease efficiently and effectively. One compromise that seems fair provides that basic material lease provisions (e.g., rent, term, options) cannot be modified without the mortgagee's consent; furthermore, the mortgagee is not bound by any changes in other terms regardless of whether it had knowledge of them, actual or constructive, unless it consented to them.

Mortgagees often seek other, perhaps less appropriate, exemptions. Mortgagees often seek to exculpate themselves from any of the landlord's construction obligations. In addition, mortgagees may seek to prevent the lease from being canceled or modified and sometimes even try to prevent the lease from being assigned.

After a foreclosure, a mortgagee may quickly become unwilling to obligate itself for certain construction in its tenant leases, arguing that it should not be required to undertake the expenditures necessary to complete a prior landlord's defaulted construction obligations. The tenant's argument is that since the construction obligations are directly or indirectly funded by the mortgagee, there is little practical difference between the mortgagee's payment of construction funds to the landlord's general contractor and its payment to a general contractor that it hires directly. The mortgagee's counter argument is that it never intended to become an owner of real estate and be forced to complete construction of a project that it must eventually sell, perhaps in a "forced" sale. That obligation would be both unfair to the mortgagee and an

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unrealistic expectation of the tenant. Equitable tenant arguments include the assertion that the tenant has foregone other competing locations and has expended time and money planning to use the lost location.

On balance, mortgagees prevail on this issue unless the tenant is a sole user or represents a large percentage of the total project. Such large tenants should be able to obtain a commitment to project completion.

However, tenants should treat lender's demands for control of the right of assignment as overreaching, and they should reject the demand. In effect, the mortgagee is asking that it be able to "unnegotiate" these rights (as well as rights respecting cancellation), which may have been created after either months of negotiation between tenant and landlord or after years of operation with such rights in place under the lease. Mortgagees must assume that the borrower/landlords are attempting to obtain the best tenants on the most landlord advantageous terms possible. If mortgagees wish to negotiate or renegotiate leases, perhaps they should take equity positions and assume responsibility for leasing.

Mortgagee's Rights to Cure

Whether or not mortgagees accept the assumption of potential liability alluded to earlier, they seek the right to cure any default of their borrower/landlord. A mortgagee's right to cure should be tempered in two ways. First, it should be subject to a tenant's overriding immediate right to cure in the event of an emergency (assuming the tenant is in possession and operating). Next, the mortgagee should have a finite, reasonable time (not unlimited) within which to effect a cure, after which the tenant may do so. This prevents the mortgagee from deferring exercising its right throughout a lengthy foreclosure process that may inhibit a mortgagee from effecting certain cures. Foreclosure in some jurisdictions can take two or three years or more.

Summary

A mortgagee wants the right, after foreclosure, to maintain forever the marriage created between its defaulted borrower and its defaulted borrower's tenant. Moreover, mortgagees want the marriage continued on their own terms and are generally not willing to make a reciprocal vow. However, most tenants are entitled to at least some loving, honoring, and cherishing. Once the parties agree conceptually on the need for reciprocity in the relationship, tenants must read the marriage contract carefully, because some rain falls on every parade. ■

ACRELades

Alfred Adams has been selected for recognition as a recipient of the 2011 Citizen Lawyer Award by the North Carolina Bar Association. The award will be presented in late June.

Fellows **David Gordon** and **Jack Fersko** planned, moderated and spoke at a seminar for the New Jersey Institute of Continuing Legal Education. An outstanding panel, including NJ Fellows **Charles Applebaum, Russell Bershad, Martin Dowd, Rich Hluchan and Michael Rothpletz**, drew an audience of over 100 for the all-day event.

Andrea Geraghty was selected for inclusion as one of the five percent of Pennsylvania attorneys listed in the 2011 Pennsylvania Super Lawyers. ■

In Memoriam

The College notes with sadness the passing of Ned M. Barnes of Spokane, WA.

Meetings Calendar

2011 Annual Meeting
October 20-23, 2011
The Westin Philadelphia
Philadelphia, PA

2012 Mid-Year Meeting
March 8 - 11, 2012
Four Season Hotel
Las Vegas, NV

2012 Annual Meeting
October 18-21, 2012
Renaissance Hotel
Chicago, IL

2013 Mid-Year Meeting
March 14-17, 2013
Naples Grande Resort
Naples, FL

2013 Annual Meeting
October 17-20, 2013
Four Seasons Hotel
Vancouver, BC, Canada

2014 Mid-Year Meeting
March 27-30, 2014
Grand Hyatt Kauai Resort and Spa
Kauai, HI

2014 Annual Meeting
October 16-19, 2014
InterContinental Hotel
Boston, MA