

PREPARING FOR THE FINANCIALLY SUCCESSFUL VOYAGE NEGOTIATING A FINANCEABLE LEASE

By: Lowell D. Salesin

I. Priority

- A. In Michigan, in the event that a mortgage is recorded prior to a tenant's occupancy or the recordation of a memorandum of lease, the mortgage will take priority over the lease and the lease is terminable by the mortgagee upon foreclosure. However because Michigan is a "race-notice" state, if a lease or memorandum of lease is recorded or if a tenant occupies a property prior to the recordation of a mortgage, the lease will take priority over the mortgage. If a lease takes priority over a mortgage, upon foreclosure, title to the commercial property is transferred to the mortgagee, and the mortgagee subsequently becomes owner of the property subject to the terms of the original lease.
- B. "A valid foreclosure of a mortgage terminates all interests in the foreclosed real estate that are junior to the mortgage being foreclosed .." *Third Restatement of the Law, Mortgages* 7.1. Under Michigan law, a junior tenant's lease is automatically terminated upon foreclosure even if the tenant is not given notice of foreclosure and/or is not named in the foreclosure action. Thus, when the mortgagor's right to possession is terminated, so too is the tenant's right to possession. Note that in Michigan, a mortgage is a lien on real estate securing payment or performance of an obligation and thus a mortgage does not operate to transfer title of the land to the mortgagee. Instead, the mortgagee simply maintains a lien on the land to secure the debt. When the lease has priority over the mortgage, the lease is not altered by a foreclosure of a mortgage. As such, "the transfer of title from mortgagor to mortgagee by virtue of the foreclosure sale, renders the mortgagee the new landlord to the tenant under the original lease for the remainder of the term..." See *Third Restatement of the Law*

7.1. While a mortgagee will be liable under most terms and conditions of the lease after foreclosure, the mortgagee will not be liable for breaches of landlord's obligations that occur prior to the mortgagee's acquisition of title, unless those breaches continue after the mortgagee's acquisition.

- II. Subordination, Attornment and Non-Disturbance Agreements Often a lender, landlord and tenant will enter into subordination, nondisturbance and attornment agreement (a "SNDA") to govern the relationship of the parties in the event of foreclosure. A SNDA typically states that the lease is subordinate to a mortgage in favor of the lender, states that the tenant will be entitled to quiet enjoyment of the property and provides the lender a way to exercise its remedies and extinguish other interests without adversely affecting the cash flow stream under the lease which provides value to the property. SNDA typically gives the lender the right to declare the lease superior to the lien of the mortgage in order to avoid any argument that the lease could be terminated upon foreclosure. Most SNDAs also require that the lender control the use of insurance and condemnation proceeds. Finally, SNDAs state that the tenant shall "attorn" to the person who purchases the property at a foreclosure sale, meaning that the tenant will be contractually bound by the term of the lease and will waive all rights to terminate the lease as a result of foreclosure. It is typical for a lease to require the tenant to execute an SNDA and to execute an estoppel certificate in which the tenant sets forth the material terms of the lease and states that the lease has not been breached or modified.
- III. Notice and Opportunity to Cure A lender typically requires that a lease contain an independent covenant whereby the tenant agrees to grant the lender notice of the landlord's default and an opportunity to cure the default. Most lenders prefer a sixty (60) day cure period, though it is not uncommon for the time period to be negotiated down to thirty (30) or forty five (45) days. A lender should be granted the opportunity to commence and diligently pursue cure within the designated period if the default cannot be completely cured within the stated period.
- IV. Tenant Offset Rights/Self-Help Rights While some leases include a right of the tenant to offset amounts due from landlord to tenant against tenant's rental

obligations to landlord, most lenders will require tenants to execute a SNDA that provides that in the event of foreclosure, the lender will not be liable for any offsets that the tenant had against the former landlord. The lender does not want to expose itself to monetary damages or impair the rental stream because of offset rights or claims which result from someone else's default. In essence, most lenders refuse to guaranty the performance of the prior landlord. A lender typically will agree to be liable for defaults of the prior landlord that continue after the lender has become the owner of the property.

V. Casualty Provisions/Insurance Requirements

- A. Most leases require tenants to maintain general liability insurance and workers' compensation insurance, if applicable. A typical lease requires the general liability policy to be written on an "occurrence" basis, to be a primary policy and to name the landlord as an additional insured party. A lender will likely require that it is named as an additional insured as well. A landlord should require that all insurance policies carried by a tenant carry an A.M. Best & Company rating of "A", Class "X" or better. A landlord should further require that the policies provide that they will not be cancelled without notice and an opportunity for the insured party to cure. Finally, a landlord should insist that the policies provide that all claims for damages to the property shall be negotiated and adjusted directly with the landlord and that the landlord and its lenders shall be the sole loss payees for any loss with respect to the property.
- B. A casualty provision is typically included in a commercial lease. The provision usually provides that if the property is completely or substantially damaged or destroyed by an insured casualty, either party may terminate the lease. If the property is not substantially destroyed, most leases provide that landlord shall use the casualty insurance proceeds to repair and restore the property to a tenantable condition at landlord's cost and expense within a specific period of time. During the time of repair, the tenant's rent should abate.