



## **Understanding the Lease Subordination Clause**

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If you own commercial rental property, your bank or other lender may request – or demand – that you include a subordination clause in your leases. Essentially, this clause states that the lease is subordinate to any existing or future mortgages on the property. Thus, if you default on your mortgage and the lender forecloses, the lender has the right to terminate the lease and evict the tenant, even if the tenant has fulfilled all of its responsibilities under the lease.

From the lender's perspective, the desire for subordination clauses makes sense. It gives the lender the option, in the event of foreclosure, to eliminate tenants that are paying below-market rent or are otherwise undesirable. But these clauses can be damaging to a tenant's business. Most tenants make a substantial investment in their offices, retail space, manufacturing plants, or other commercial facilities. A subordination clause puts them at risk of losing their business location – which can be critical to their operations and customer relationships – through no fault of their own. In addition, they risk losing any investments in leasehold improvements.

Unfortunately, property owners are often “stuck between a rock and a hard place.” Lenders may insist on subordination clauses while prospective tenants are strongly opposed to them. To deal with these issues, owners should familiarize themselves with lease priority rules and with strategies that can protect the interests of both lenders and tenants.

### **Lease Priority Rules**

To assess the impact of a subordination clause, you first need to understand the general lease priority rules. Absent a provision in the lease agreement to the contrary, a new lease is automatically subordinate to any existing mortgage on the property (provided the lender has properly recorded the mortgage or the tenant otherwise has notice of it). Conversely, without a subordination clause, any mortgages recorded after a lease is in place will be subordinate to the tenant's rights in the leased premises.

In light of these rules, lenders often require subordination clauses as a condition of a new loan secured by the property, while tenants may be reluctant to lease mortgaged property without the protection of a nondisturbance agreement.

### **Using a Non-disturbance Agreement**

One solution to subordination issues is to ask the lender to enter into a non-disturbance agreement with the tenant. This agreement prohibits the lender from interfering with the tenant's use of the premises so long as the tenant continues to pay rent and otherwise comply with the lease agreement's terms and conditions.

To protect the lender's interests, a non-disturbance agreement may include certain conditions. For example, it may provide that you and the tenant cannot modify the lease without the lender's approval, or that in the event of foreclosure, the lender will not be liable for any prepaid rent, security deposits, or unperformed landlord obligations. The lender may also insist that the tenant's rights under a non-disturbance agreement are contingent on certification by a qualified, independent appraiser that lease payments reflect the property's fair market rental value.

### **Be Prepared**

In today's struggling real estate market, it's important for you to understand the impact of subordination clauses on both tenants and lenders. Be prepared to negotiate provisions that provide for financing and are acceptable to prospective tenants.