5-2008

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Aviel v Ng

The decision in Aviel v Ng (2008) 161 CA4th 809, 74 CR3d 200, reported at p 78, would be noteworthy only if it had gone the other way—if, for instance, it had held that a deed of trust is subject to different rules than is a mortgage; or that a mortgage (or deed of trust) that is prior to a lease does not terminate the lease when it is foreclosed; or that a mortgage that was executed after a lease is still not superior to it even though there was a subordination clause in the lease. Since this opinion was clearly “correct” in holding the opposite of all of those positions, there is really no need for attorneys to make any “midcourse corrections” in their drafting of these documents. This column is mainly to remind counsel to make sure that their clients really do want what they are fighting for when they deal with the lease versus loan priority issue.

The lease in Aviel was executed two years before the deed of trust on the same premises was signed. However, the lease contained a subordination clause, so the foreclosure of the deed of trust (five years later) inevitably terminated the leasehold, which otherwise might have continued for another 20 years. The tenants should properly berate themselves for having so carelessly agreed to this possible wipeout. That was the clear and foreseeable effect of the subordination clause.

But that fact represented a loss for the tenants (and a win for the trustee sale purchaser) because rental values had since gone up. (The trial court’s award of $125,000 damages for 20 months’ holdover seems to set a monthly rental value of over $6000, as opposed to monthly rent reserved under the lease of less than $5000.) Had rental values gone down instead, the tenants would have regarded themselves as winners because of the fortuitous termination of their lease by virtue of the trustee sale. In that case, the loser would be the foreclosing lender (who could now expect to sell for that much less), the debtor/landlord (who would get that much less surplus), or the trustee sale purchaser (unless it took that into account in its bid), because tenants paying an above-market rent after the sale was completed could not be made to stay after the foreclosure sale of a prior mortgage automatically ended their rent liability.

The Downside of Being First

With an unmitigated subordination clause in a lease, there is always a winner and loser—depending on which way the market goes. If it goes up, the lender is the winner because more rent can be demanded for letting the tenant stay. If the market goes down, the tenant is the winner because it can insist on a lower rent as a condition for staying. The same is true for those cases when the loan was prior to the lease because it was executed first, and the reverse is true when the lease came first and contained no subordination clause.

Subordination clauses are included in most leases because landlords put them there. Landlords put them there because they anticipate that later lenders will be more agreeable to making loans to them if they see such provisions there. A subordination clause makes the lender’s deed of trust first rather than second in priority. But is that always a good thing?
From a lender’s perspective, it is always better to be a first lender rather than a second lender. It gets paid first, and any shortfall hits the junior lenders instead. But when the priority issue is between a loan and a lease, the value of being first is not as clear. As this case holds, foreclosure of a senior loan automatically terminates a junior lease and lets any tenant whose rental obligations exceed the rental value of the premises—the very ones that the lender and foreclosure purchaser would most like to hold in that situation—walk away. But, on the other hand, had that loan not had priority over the lease, its termination by foreclosure would not have affected the existing lease, and that desirable tenant could not escape. Priority is not always best. (Everything said about the lender in this case is true—vice versa—for the tenant.)

I think concentrating on the presence or absence of a subordination clause in a lease is not what the parties should most be worrying about.

**Who Wants to Be a Gambler?**

Tenants who bargain for long-term leases obviously want assurances of stability: They wish to avoid the risks of renegotiating renewals and rents with their landlords too often thereafter. Since the nominal duration of a lease is meaningless if it can be prematurely terminated by a foreclosure sale, they should obviously be more careful than Ng was in signing a lease that includes a bald subordination clause.

But it may be no less true that lenders who finance rental property seek similar assurances of stability: They wish to avoid the risk that the income streams that currently justify the underwriting of their loans will vanish in the future—and would much prefer that those income streams survive any foreclosures they may have to conduct, which may make those properties more attractive to purchasers. Financing property that was currently subject to a subordinated lease may have been as careless on Aviel’s part as signing the lease was on Ng’s part. Both got chances of winning and losing, but neither got the kind of comfort they should have wanted. Both should have been more risk averse.

**Forget the “S”; Go for the “NDA”**

A tenant’s real concern should be whether its lease will survive the landlord’s mortgage default, not whether the lease is senior or inferior to that mortgage. If the tenant is asked to subordinate its lease to a later mortgage, agreeing to do so will not hurt as long as that subordination is conditioned by a nondisturbance provision in the lease, assuring that the foreclosure will not destroy the leasehold. (These agreements, combining subordination, nondisturbance, and attornment provisions, are commonly referred to as SNDAs.) Without the nondisturbance provision, the tenant will suffer Ng’s unhappy fate. Bargaining should be over the nondisturbance details as to how the tenant will have to behave to be sure that its rights under the old lease continue after a mortgage foreclosure.

Since a subordination clause in a prior lease can be equally risky for a lender (if the rental market goes down), the lender, too, should prefer to see it qualified. If the lender is satisfied with the current leasehold status, a nondisturbance provision protecting the tenant does the loan no harm. Because the lender’s greatest worry may be that the tenant will use the confusion of trustee sale proceedings as an occasion to quit the premises, what the lender should most want to see included in that prior lease is an attornment provision, compelling the tenant to acknowledge the lender and the foreclosure purchaser as the tenant’s new landlord, and guaranteeing the survival of the lease after the sale. Bargaining should be over the attornment details as to how the lender
and purchaser will have to behave to be sure that their rights under the old lease continue after the foreclosure sale.

If those necessary nondisturbance and attornment provisions are in their documents, I think it will hardly matter whether there is or is not a subordination provision, nor indeed which interest would otherwise be prior to the other. Arguing over the features of the subordination clause is bickering over the least important issue. Using a lease that includes such a clause and nothing else—as happened here—is dangerous.

Aviel v Ng (2008) 161 CA4th 809, 74 CR3d 200

In September 1998, the Ngs entered into a commercial lease with their landlord that contained a clause subordinating the lease to future “mortgages” on the property. In December 2000, Aviel loaned money to a third party to purchase the property from the Ngs’ landlord. A deed of trust in favor of Aviel secured the loan. In March 2002, Aviel acquired the property through a trustee sale. Thereafter, he negotiated a new lease with each of the property’s tenants, except the Ngs. In June 2003, Aviel filed an unlawful detainer action against the Ngs. They vacated the property in November 2003 and Aviel converted the unlawful detainer into an action for reimbursement of reasonable rental value.

The Ngs cross-complained against Aviel, alleging numerous causes of action. Aviel moved for summary judgment on the claims for breach of contract, wrongful eviction, and specific performance, on the ground that each cause depended on a valid lease, but the lease was extinguished by the subordination clause at the time of the trustee sale. The Ngs argued that the subordination clause applied to “mortgages” and therefore the lease had not been extinguished by the trustee sale under the deed of trust. The trial court disagreed and Aviel prevailed on the rent claim, because once the lease expired, the Ngs, as holdover tenants, owed market rate rent. The Ngs prevailed only on a claim for conversion of their equipment, and then appealed the claims they lost.

The court of appeal affirmed the trial court judgment in its entirety, noting that it has long been settled that:

- Mortgages and deeds of trust are functionally and legally equivalent; and
- A lease otherwise senior to a deed of trust may be subordinated by agreement.

Moreover, once the lease was extinguished, the Ngs became holdover tenants, liable for rent at the market rate, not the lesser rent specified in the lease.