

# **From Lender to Landlord (and Tenants Too!) – How Foreclosure Affects a Commercial Lease**

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## **From Lender to Landlord (and Tenants Too!) – How Foreclosure Affects a Commercial Lease**

An attorney who represents lenders, landlords or tenants and understands the effects of a foreclosure on commercial leases can neutralize those potential consequences as early as the drafting and negotiation stage of the transaction.

### **I. Subordination, Non-Disturbance and Attornment Agreement**

In general, a properly conducted foreclosure sale will terminate subordinate leases, but there are ways for the lender and tenant to adjust this outcome through agreements such as subordination, non-disturbance and attornment (“SNDA”) agreements. An SNDA is a contract between a tenant and the lender which governs the relationship and rights of those parties after a foreclosure by the lender.

Breaking down the pieces of an SNDA, generally speaking:

The “subordination” provision requires the tenant to subordinate its lease to the lender’s security deed.

The “attornment” provision requires the tenant to attorn to, or recognize, the lender as its landlord upon a foreclosure.

The “non-disturbance” provision is a promise by the lender not to disturb the tenant’s tenancy or terminate its lease. A tenant may also specifically contract for the lender to honor certain lease provisions in the event of a foreclosure, such as rent abatements or renewal options, which the lender’s “form” SNDA likely excludes.

Upon a foreclosure, the SNDA will control the relative priority of the lender’s security deed and the tenant’s lease, as well as other concerns such as the terms of the lease which the lender will honor. A tenant may request an SNDA, for example, in order to protect its investment in the premises or concessions which are due to the tenant later

in the lease term (e.g., delayed free rent or future TI allowance). The SNDA gives the lender comfort that the tenant will remain “on the hook” after a foreclosure.

## **II. Relationships After the Foreclosure Sale In the Absence of an SNDA or Other Agreement Between the Lender and Tenant.**

If the lender and tenant do not have an agreement such as an SNDA in place, then the parties’ relationship after a foreclosure is determined by the relative priority of the lease and the lender’s security instrument. The relevant inquiry is whether the lease was entered into before or after the security deed was entered into.

Georgia follows the “race-notice doctrine” that gives priority to the instrument that is recorded first in time.<sup>1</sup> That is, a prior unrecorded deed from Party A (the “Unrecorded Deed”) loses its priority over a subsequent recorded deed from Party A (the “Recorded Deed”) when a purchaser takes the Recorded Deed without notice of the existence of the Unrecorded Deed.

In determining the relative priority of a lease and security deed, it is important to note that even if the landlord and tenant do not record a “memorandum of lease” in the public deed records, the case law interpreting the race notice doctrine requires one to assume that a lender has notice of any lease in effect as of the date of the lender’s security deed (since the tenant is in possession of its premises).<sup>2</sup>

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<sup>1</sup> O.C.G.A. § 44-2-1

<sup>2</sup> See Turner Communications Corp. v. Hickcox, 161 Ga. App. 79 (1982) (purchaser of leased premises is charged with notice of the rights of a lessee in possession, whether or not the lease is recorded); Yancey v. Montgomery & Young, 173 Ga. 178 (1931) (holding that persons purchasing or contracting for a lien on land must inquire into the right of any occupant thereon).

### **A. Lease entered into before security deed**

When the lease is entered into before the security deed, the foreclosure will not terminate the lease.<sup>3</sup> Under the race-notice principle that the first in time is the first in rank, the rights of the tenant are superior to those of a subsequent lienholder.<sup>4</sup> Therefore, the party acquiring title by foreclosure “takes subject to the terms of such written lease.”<sup>5</sup>

There is an exception to this general rule in cases where a “first in time” lease contains a clause providing that the lease is made subject to any future security deed; in such a case, the tenant’s lease is subordinate to a subsequent security deed, and as such, a foreclosure terminates that lease.<sup>6</sup> Such a tenant will become a tenant at sufferance and the party acquiring title at a foreclosure sale may maintain a statutory eviction proceeding against the tenant.<sup>7</sup>

### **B. Lease entered into after security deed**

When the lease is entered into after the security deed, the foreclosure will terminate the lease, and the tenant becomes a tenant at sufferance.<sup>8</sup> A tenant at sufferance is “one who comes into possession of land by lawful title, but keeps it

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<sup>3</sup> Wright v. Home Beneficial Life Ins. Co., 155 Ga. App. 241, 242 (1980) (citing Richardson v. Lampley, 107 Ga. App. 395 (1963)).

<sup>4</sup> Trust Co. Bank v. Atlanta Speedshop Dragway, 208 Ga. App. 867 (1993).

<sup>5</sup> Richardson, 107 Ga. App. at 396.

<sup>6</sup> Wright, 155 Ga. App. at 242. See also Trust Co. Bank, 208 Ga. App. at 868 (1993).

<sup>7</sup> Trust Co. Bank, 208 Ga. App. at 868.

<sup>8</sup> Wright, 155 Ga. App. at 242. See also First Fed. Savings & Loan Ass’n of Atlanta v. Shepherd, 131 Ga. App. 692, 693 (1974) (explaining that the policy underlying this rule is that the lessee has constructive notice of the new owner’s right to terminate the lease).

afterwards without any title at all.”<sup>9</sup> As such, the new owner who acquires title by foreclosure may bring a statutory eviction proceeding against the tenant.<sup>10</sup>

Foreclosure sale purchasers should note, however, that “it takes very little to convert a tenancy at sufferance into a tenancy at will.”<sup>11</sup> Collecting or even demanding rent or any other indication that the new owner will allow the tenant to remain in possession will convert the tenancy at sufferance into a tenancy at will.<sup>12</sup>

For example, in *Diner One, Inc. v. Bank South, N.A.*, the tenant’s lease was made subject to an existing security deed.<sup>13</sup> After the foreclosure, the tenant became a tenant at sufferance. However, once the bank purchased the property at the foreclosure sale, the bank demanded rent from the tenant. The Georgia Court of Appeals found that the bank’s demand converted the tenancy at sufferance into a tenancy at will.<sup>14</sup>

In a race-notice state like Georgia, a lender could foreclose on a building and find itself with a building-full of tenants at sufferance. In such a case, if the new owner wants to keep the tenants, it should immediately send notices to the tenants regarding rent collection and renegotiate leases shortly thereafter. However, even if the new owner is able to convert the tenancy at sufferance into a tenancy at will, the tenant or new owner may terminate with 30 days’ and 60 days’ prior notice, respectively.<sup>15</sup>

To avoid these uncertainties, lenders and tenants often rely on provisions like the subordination, non-disturbance and attornment agreement, as discussed above.

**Practice Tip:** A Tenant is not entitled to notice of foreclosure in order for a foreclosure to be properly conducted, regardless of whether the tenant has substantially

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<sup>9</sup> *Diner One, Inc., v. Bank South, N.A.*, 219 Ga. App. 702, 703 (1995).

<sup>10</sup> *Wright*, 155 Ga. App. at 242.

<sup>11</sup> *Diner One*, 219 Ga. App. at 704.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> O.C.G.A. § 44-7-7.

improved the property. Therefore, it is prudent for a tenant who is investing in substantial improvements, particularly if they are at tenant's cost, to negotiate for an SNDA at the time of the lease negotiation, and for the tenant to require landlord and lender to give tenant notice of any foreclosure of the property. Similarly, from a lender's perspective, the lender may want to negotiate a term in the security deed to require the borrower to obtain lender's consent to future leases of the property so the lender is aware of terms of leases that the lender might want to "take subject to" in the event of a foreclosure.

### **III. Post-Foreclosure Tenancies**

#### **A. Effect of Foreclosure on Written Lease Terms**

If the lease predates the security deed and the lease was not made subject to any future security deed, the new owner will take the property subject to the written lease and all of its terms.

If the foreclosure terminates the leasehold estate, then the written lease is no longer in effect and the new owner may evict the tenant at sufferance using summary proceedings.<sup>16</sup> Though tenants at sufferance are obligated to pay the reasonable rental value of the premises or the amount of rent previously established, whichever applies,<sup>17</sup> generally, this only becomes an issue in a dispossessory proceeding. Recall that if the landlord accepts rent, the tenancy is converted into a tenancy at will, and general terms and conditions of the existing lease remain in effect.

As soon as the tenant is classified as a tenant at will, the existing lease's general terms and conditions will apply. "General terms and conditions" are those which are indispensable to a continuing landlord/tenant relationship or those necessary in order for the landlord/tenant relationship to continue.<sup>18</sup> Some examples are:

- Repair obligations of the landlord and tenant;<sup>19</sup>

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<sup>16</sup> Carruth v. Carruth, 77 Ga. App. 131, 135 (1948).

<sup>17</sup> Britton, 307 Ga. App. at 582; Bellamy, 236 Ga. App. at 751

<sup>18</sup> Midtown Glass Co., LLC v. Levent Industries, Inc., 316 Ga. App. 422, 423 (2012).

<sup>19</sup> Gully v. Glover, 190 Ga. App. 238, 240 (1989) (quoting Colonial Self Storage, of the Se., Inc. v. Concord Prop., 147 Ga. App. 493, 494 (1978)).

- Rent payable under the lease;<sup>20</sup>
- Lease provision requiring tenant to pay for damages to the premise;<sup>21</sup> and
- Lease provision requiring tenant to pay a proportional share of the landlord's operating costs, including taxes, maintenance, security, and insurance.<sup>22</sup>

Some examples of terms and conditions of the lease that courts have found are not indispensable to the continuing landlord/tenant relationship, and which would therefore not apply in a post-foreclosure tenancy at will:

- Lease provision granting the contractual right of first refusal to lease the property;<sup>23</sup> and
- Lease provision requiring a waiver of subrogation.<sup>24</sup>
- ***Practice Tip:*** While there is no case law in Georgia requiring a lender to honor a former landlord's promise to provide rent abatements, tenant improvement dollars, or other concessions, it would be wise for a Tenant to protect these rights at the lease negotiations stage by requiring an SNDA from the landlord's lender.

## **B. Tenant's termination rights**

If the lease predates the security deed and the lease was not made subject to any future security deed, then the foreclosure sale does not terminate the lease, and the tenant does not have any common law right to abandon or terminate its lease.<sup>25</sup>

Recall that lenders and tenants may adjust the relative priority of the security deed and lease with an SNDA or similar agreement. However, in the absence of an SNDA, when the lease is entered into after the security deed is in place, the foreclosure

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<sup>20</sup> Id.

<sup>21</sup> Id.

<sup>22</sup> Radha Krishna v. Desai, 301 Ga. App. 638, 640-41 (2009)

<sup>23</sup> Mariner Healthcare v. Foster, 280 Ga. App. 406, 409 (2006).

<sup>24</sup> Midtown Glass Co., LLC v. Levent Industries, Inc., 316 Ga. App. 422, 425 (2012) (This provision is merely a reallocation of risks and not necessary for the landlord/tenant relationship to continue.).

<sup>25</sup> Wright, 155 Ga. App. at 242 (quoting 51C C.J.S. 307, Landlord & Tenant § 93(5)).

terminates the leasehold estate and the subordinate lease, so the tenant may move out without further ado.

A lender may avoid this situation by subordinating its security deed to the previously subordinate leases and therefore selling the property at foreclosure *subject to those leases* (meaning that the leasehold estate would survive the foreclosure). In such a case, the lender is advised to advertise the property for the foreclosure sale with the information about the leases, notify the existing tenants of the subordination, and include language in the Deed Under Power that the property is being sold subject to the leases.

***Practice Tip:*** The lender should consider carefully whether to include language in the Deed Under Power that makes the security deed junior to otherwise subordinate leases because the decision whether to do so should be influenced by the strength of the leases, whether there are any leases at the property which may not be financially viable, and the number of leases affecting the property. There is no support in Georgia law for a lender to “cherry pick” the leases that have more financial benefit to the lender or new owner, so to be safe, the lender should choose to subordinate to either all the leases or none of them.

### **C. Landlord’s Termination Rights**

A landlord may terminate a tenancy at will with 60 days’ notice, and there is no notice required to dispossess a tenant at sufferance. The landlord or owner needs to take care to avoid liability for wrongful eviction. Wrongful eviction is a malicious and forcible eviction of the tenant by the landlord, where even though a warrant to dispossess has been issued, the tenant has not breached the contract of rental and is entitled to possession of the premises.<sup>26</sup> To avoid liability for wrongful eviction, the foreclosure sale purchaser should follow the statutory dispossessory procedures set

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<sup>26</sup> Mizell v. Byington, 73 Ga. App. 872 (1946).

forth in O.C.G.A. § 44-7-50 et seq. and verify that the tenant has failed to relinquish possession as a tenant at will or sufferance.<sup>27</sup>

A landlord cannot avoid liability for violating Georgia eviction procedures by delegating such responsibility to an independent contractor.<sup>28</sup> In *Ikomoni v. Executive Asset Management, LLC*, the lender hired an asset management company to clean up and market the foreclosed property. The asset management company then hired a real estate holding company to perform an inspection and clean the property. The real estate holding company changed the locks, preventing the former owners from entering the property. The former owners brought suit for wrongful eviction and trespass, claiming that the new owner should have followed dispossessory procedures. The appellate court upheld the trial court's grant of summary judgment in favor of the lender based on other grounds<sup>29</sup> but also held that the two independent contractors were not liable for failing to carry out the lender's statutory duty of following the dispossessory procedure. The court held that the statutory procedure was a non-delegable duty and the independent contractors had no separate legal duty to file the dispossessory action.<sup>30</sup>

#### **IV. Relevant Federal Statutes**

##### **A. Servicemembers' Civil Relief Act**

Under the Servicemembers' Civil Relief Act § 301(a), a landlord may not evict a servicemember or the dependents of a servicemember during a period of military service of the servicemember from premises that are occupied as the primary residence without

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<sup>27</sup> *Thrift v. Schurr*, 52 Ga. App. 314 (1935); *Price v. Bloodworth*, 55 Ga. App. 268 (1937); *Cunningham v. Moore*, 60 Ga. App. 850 (1939).

<sup>28</sup> *Ikomoni v. Executive Asset Management, LLC*, 309 Ga. App. 81, 84-85 (2011).

<sup>29</sup> *Id.* (failing to respond to Requests for Admissions).

<sup>30</sup> *Id.*

a court order.<sup>31</sup> Under an application for eviction, the court may stay the proceedings for 90 days or adjust the obligation under the lease to preserve the interests of all parties.<sup>32</sup> A landlord should include a lease provision requiring any tenant to notify the landlord within ten (10) days of military service as a servicemember, so that the landlord may be on notice if the tenant/servicemember fails to make rent payments. In addition, before beginning the eviction proceedings, the landlord may wish to confirm with the Department of Defense if the tenant is a servicemember actively serving a period of military service.<sup>33</sup>

### **B. Protecting Tenants at Foreclosure Act:**

Even if the property is a commercial foreclosure, the Protecting Tenants at Foreclosure Act (“PTFA”) can still affect a foreclosure sale purchaser of any commercial property in which people are residing (e.g., a rented spec home in a residential development). Generally speaking, following foreclosure, the PTFA requires the new owner to provide bona fide tenants with 90 days’ notice prior to eviction. Further, bona fide tenants with leases may occupy the property until the end of the lease term, unless the new owner plans to occupy the property.<sup>34</sup>

A lease or tenancy is considered bona fide only if (1) the mortgagor or the child, spouse, or parent of the mortgagor under the contract is not the tenant; (2) the lease or tenancy was the result of an arms-length transaction; and (3) the lease or tenancy requires the receipt of rent that is not substantially less than fair market rent for the property or the unit’s rent is reduced or subsidized due to a Federal, State, or local

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<sup>31</sup> 50 U.S.C. App. § 531(a).

<sup>32</sup> Servicemembers’ Civil Relief Act § 301(b); 50 U.S.C. App. § 531(b).

<sup>33</sup> <http://www.dfas.mil/garnishment/verifyservice.html>

<sup>34</sup> 123 Stat. 1632, 1660-1661.

subsidy.<sup>35</sup> The PTFA will expire on December 31, 2014. The 11<sup>th</sup> Circuit has found that a month to month tenancy can be terminated under the PTFA with a 90 days' notice to the tenant.<sup>36</sup>

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<sup>35</sup> Harper v. JP Morgan Chase Bank Nat'l Ass'n, 305 Ga. App. 536 (2010).

<sup>36</sup> Joel v. HSBC Bank USA, 420 Fed. Appx. 928 (11<sup>th</sup> Cir. 2011).