California Public Policy
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The Aetna court concluded that Muggill represents the long-held California view that an agreement that financially penalizes an employee who goes to work for a competitor is unlawful under Section 16600.

The bottom line is that California employers should approach non-competition agreements with great caution. Nonsolicitation clauses, which restrict soliciting employees or customers after an employer's departure, may also be drafted so broadly that they become illegal non-competes. Employers are well advised to have all agreements with nonsolicitation and non-compete provisions reviewed by legal counsel. California courts will in all likelihood find anything which impedes an employee's opportunity to work unenforceable.

Lori A. Lutzker is a member of Carr, McClellan's Corporate & General Business Law Group. Elisë Clowes is a member of Carr, McClellan's Labor & Employment Group.

Privacy Policy Notice

Attorneys, like other professionals who advise on personal financial matters, are now required by a new federal law to inform their clients of their policies regarding privacy of client information. Attorneys have been and continue to be bound by professional standards of confidentiality that are far more stringent than those required by this new law. California Business and Professions Code Section 6068(e) requires an attorney "To maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client." Therefore, we have always protected your right to privacy.

In the course of providing our clients with income tax, estate tax, gift tax and estate planning advice, we receive significant personal financial information from our clients. As a client of our firm, you should know that all information that we receive from you is held in confidence, and is not released to people outside the firm, except as agreed to by you, or as required under an applicable law.

We retain records relating to professional services that we provide so that we are better able to assist you with your professional needs and, in some cases, to comply with professional guidelines. In order to guard your nonpublic personal information, we maintain physical, electronic, and procedural safeguards that comply with our professional standards.

Time for a Software Audit?
(continued from page 7)

The don'ts – These include prohibited acts without the advance approval of a designated person (or unit): (1) purchase software for company use or installation on company computers; (2) download and/or install software to a company computer; (3) use any unauthorized software on company computers; (4) install or use company licensed software on employee, agent or customer owned computers; (5) copy or modify any company licensed software; and (6) distribute or permit access to company licensed software to any third party, including agents, contractors and customers.

Your company's particular circumstances may require modification of these permitted and prohibited acts. Nonetheless, a good software management program including a Software Policy Statement can help reduce your risk of liability as well as your bottom line costs associated with the purchase and use of licensed software.

Barry J. Parker is Special Counsel for Intellectual Property law matters and a member of Carr, McClellan's Corporate & Business Law Group.

On-Campus Recruiting

Carr, McClellan has a strong relationship with a number of the law schools in our area and recruits annually on campus. Each summer, we hire law students who have completed their second year of law school as summer associates.

As a result of our on-campus recruiting efforts last year, Susan Isard, a second year student at Hastings School of Law, will join the firm as a summer associate this summer. Susan is a 1996 graduate of the University of Chicago where she earned her degree in Humanities. She will be assigned to an attorney who will coordinate and supervise her work to ensure that she obtains a variety of experiences, such as attendance at depositions and trials, business and real estate negotiations, and legal research and writing. We are very excited that Susan has chosen to spend her summer at Carr, McClellan, and hope that it will be a rewarding experience for her.

In the fall of this year we expect to interview second year law students for the summer of 2003 at the following law schools:

University of California in Berkeley
(Boalt Hall)
•
University of California
Hastings College of the Law in San Francisco

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"Perspectives on Law" is published by Carr, McClellan, Ingersoll, Thompson & Horn Professional Corporation, Mark A. Cassanego, President. Our goal is to provide clients and friends of the firm with more than just updates on how the law is evolving. We hope to share our perspectives so that your businesses and families can make the most of the opportunities before you.

Carr, McClellan, founded in 1945, is located in Burlingame. The firm provides full-service legal advice to many closely-held businesses and major corporations in the Bay Area's leading industries, as well as to investors and families.

This newsletter is for general information purposes only and is not intended to offer legal advice on specific cases. Please contact your Carr, McClellan attorney to determine how this information might affect you.

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PERSPECTIVES ON LAW

Vol. 8 No. 4
Winter 2002

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Greetings

By Mark A. Cassanego, Esq.

We hope that this Winter 2002 issue of *Perspectives* finds you well treated by the advent of the new year and that its prospects are developing positively. Given the tragedies of September 11th and its aftermath, plus the stresses brought on by the economic times, I think we are all glad to have 2001 behind us. As we move forward into 2002, please know that we at Carr, McClellan are dedicated, as we have been for the past fifty-six plus years, to serving you and our community through whatever challenges lie ahead.

As lawyers, we most often are asked to be of service during life's most stressful events, whether they involve litigation, business or real estate transactions or trust and estate planning and administration. You can trust that our attorneys and staff will help lead, support and guide you through any personal or business challenges that confront you.

Looking back on the year 2001, we want to thank all of you for your business and support. We truly value the relationships we have formed and strengthened over the past year. Your patience during our remodeling project has been greatly appreciated, especially as we shifted from office to office and from conference room to conference room. Despite the physical inconveniences that we have frequently asked our clients, friends and staff to bear, we are thankful that we have been able to maintain our service to you at the highest level without interruption.

Kudos and huge thanks go to **Jan Mendez**, our Executive Director, and **Ann Von Platen**, our Human Resources Manager, for their tireless hours spent managing the process. With the exterior and interior of the firm's building and offices never looking better, we anticipate years of comfort, enjoyment and increased productivity which our new environment brings.

Although the physical surroundings of our firm may look new and updated, the same "old" people continue to work for you. In this issue, **Carol Schwartz**, the Chair of our Real Estate Group, discusses an important and complex issue to which commercial tenants are often oblivious, but which can cause catastrophic consequences for the tenant. **Elisë Clowes**, who leads our Employment Law team, and **Lori Lutzker**, a partner in our Business Law Group, warn employers to use caution when asking employees to sign "boilerplate" Proprietary Information, Nondisclosure or Trade Secret Agreements which contain "non-compete" provisions.

All of you who may have unlicensed software on your computer system should read with care the article by **Barry Parker**, of our Business Law Group, which asks the rhetorical question, "Time for a Software Audit?" Finally, **Chang Chae**, a member of our Family Wealth & Tax Planning Group, gives you some good news about recent IRS regulation changes which simplify rules pertaining to minimum distributions from Individual Retirement Accounts.

We are very pleased and excited to announce that on February 1, 2002, we added a new partner to our Family Wealth & Tax Planning Group. **Matt Wesley** is a Stanford Law School graduate who practiced in the complex litigation arena with large high quality law firms before finding his niche in estate planning. He successfully launched and grew his own entrepreneurial estate planning practice in Menlo Park until we enticed him to join forces with us. Matt's talents and experience will add depth and breadth to our team and will assist us in serving both existing and new clients of the firm.

As always, we hope that this issue of *Perspectives* is of interest to you and that it provides you with useful information. We look forward to continuing to serve you in 2002 and beyond. From all of us at the firm, we wish you the healthiest, happiest and most prosperous of New Years.

Mark A. Cassanego, Esq. is President of the Firm.

LUTHER MAYNE CARR
1906 – 2001

Our founding partner, Luther Mayne Carr, died on August 4, 2001, shortly after celebrating his 95th birthday. Luther was born in Illinois, educated at Drake University (AB 1927; JD 1929) and practiced law in Iowa before coming to California as Regional O.P.A. Attorney during World War II.

In 1945 he joined Edward H. Cosgriff to form what is now our firm. He carefully laid the foundation on which our firm was built and established principles which still serve our firm well. He insisted that each lawyer in the firm become a leader in his/her own practice area, maintain the highest standards of ethics, and give back to the community by participating actively in it. He was a great mentor to some of the older attorneys in the firm who practiced actively with him.

He maintained a keen interest in the progress of the firm during his more than 30 years of retirement and was an inspiration to all of us. He will be long remembered with great fondness.

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Estate Planning

Good News for IRA Owners: Simplified Minimum Distribution Rules

By Chang H. Chae, Esq.

Earlier this year, the IRS issued new proposed regulations that greatly simplify the rules for determining the minimum amounts required to be distributed from "IRAs," including Individual Retirement Accounts, 401(k)s, Keoghs, profit-sharing or similar types of "qualified" retirement plans. The new rules not only eliminate the need for certain elections and designations which were required under the old rules but also the "gotcha" effects of failing to make such elections and designations or of making the wrong elections or designations.

Overview of New Regulations

Based on our review of the new regulations and some of the commentary that has followed, we believe that the new rules have eliminated many of the problems and complications that existed under the old rules. The two principal changes made by the new rules are:

1. For lifetime required distributions, all IRA owners will use a uniform table for determining their "required (annual) minimum distributions." Under this uniform table, the only variable is the IRA owner's age. It no longer matters whether or not the IRA owner has a designated beneficiary or who that beneficiary is. Nor is it necessary to elect whether to "recalculate" or "not recalculate" the IRA owner's life expectancy or the life expectancy of the IRA owner's spouse.

2. For post-death required distributions, the minimum distribution rules will be based on the identity and ages of those persons who *actually* inherit the IRA. Under the old rules, post-death minimum distributions were based on the designated beneficiaries who were in place as of the IRA owner's *required beginning date* (see definition under "Unchanged Requirements").

"It no longer matters whether or not the IRA owner has a designated beneficiary or who that beneficiary is."

Lifetime Required Distributions

Under the new regulations, the required lifetime distributions for all IRA owners (except for those whose designated beneficiary is a spouse more than 10 years younger than the IRA owner) will be based on a uniform table (the Minimum Distribution Incidental Death Benefit or MDIB table), *regardless of the existence or identity of any designated beneficiary*.

The MDIB table bases minimum distributions on the joint life expectancy of the IRA owner and a hypothetical person 10 years younger than the IRA owner. This joint life expectancy is also recalculated annually under the MDIB table. If the spouse-is-more-than-10-years-younger exception applies, the IRA owner may use the actual joint life expectancy of the IRA owner and the spouse in determining the required lifetime distributions.

Under the old rules, the former MDIB table applied *only* to IRA owners who designated individual non-spouse beneficiaries (e.g., children or grandchildren) more than 10 years younger than the IRA owner. Other complex rules applied in all other cases. Thus, the new rules will result in *reducing* the required lifetime distributions for a large majority of IRA owners. For example, under the new MDIB table, the required minimum distribution for an 80-year-old person (married or single) with an IRA account balance of $100,000 would be $5,680.

The new rules also eliminate many of the following income tax considerations involved in choosing a designated beneficiary:

1. It is not necessary to have a designated beneficiary in place as of the *required beginning date*. Because of the use of the MDIB table, the designation of a beneficiary will not affect the IRA owner's required lifetime distributions.

2. The IRA owner may change the designated beneficiaries at any time (even after the *required beginning date*) without affecting the amount of his or her required lifetime distributions.

3. It is no longer necessary to make an irrevocable election (on or before the *required beginning date*) as to whether or not to recalculate the IRA owner's or the spouse's life expectancy for minimum distribution purposes; recalculation is already built-in to the uniform MDIB table.

Post-Death Required Distributions

The new regulations also greatly simplify the rules for determining the required minimum distributions after an IRA owner's death.

Strategies For Business

Time for a Software Audit?

By Barry J. Parker, Esq.

So, how many unlicensed copies of software reside on your company's computers? If you cannot answer this question with a confident "absolutely none," now is the time to conduct an internal audit of your company's software licenses before such an audit is unwillingly forced upon you.

Most software licenses limit the use of purchased software to one computer or, in the case of a network version, to a company's local or wide area network (typically limiting the number of authorized users). In some instances, a license will limit the use of software to a company's particular location (a "site" license with or without a limited number of users).

Many companies are either unfamiliar with the terms of their software licenses or simply lose track of the original licensed copy of the software. As a result, companies innocently (or not so innocently) copy the software from computer to computer (or add excessive users) without purchasing additional licenses. These unlicensed copies are in most cases a violation of the original license agreement as well as a violation of U.S. and international copyright law.

Software piracy is a real "bottom line" problem for software developers. If a software company finds out that your company has made unlicensed copies of its software, it has a real incentive to seek legal action. Under copyright law, your company's liability for copyright infringement can add up to either:

1. the amount of your company's profit from the infringement plus the software company's actual damages, or

2. statutory damages ranging from $200 (if innocent) **up to $150,000** (not so innocent) for infringement of each software product.

Plus, you will likely have to pay the software company's attorneys' fees and costs, not to mention additional new license fees to continue use of the software product.

Given the sharp teeth of copyright law, an international "who's who" of software developers have come together to form the **Business Software Alliance (BSA)**, a membership organization whose mission is to bite software pirates (innocent or not) in the wallet.

"If a software company finds out that your company has made unlicensed copies of its software, it has a real incentive to seek legal action."

More often than not, disgruntled employees anonymously contact the Business Software Alliance and fink on their employers who have made unlicensed copies of a BSA member's software. Then, the company is forced to react by either: 1) cooperating and settling the matter on BSA's terms, which require the alleged offender to conduct an internal audit of the company's software (copies v. number of licenses with paid receipts), the payment of past and future license fees plus an amount equating to attorneys' fees; or 2) defend a lawsuit and pay, pay, pay. The BSA strategy is a "pay me now, or pay me later" approach, and it is an effective one.

From time to time, the BSA offers a "Grace Period" for businesses located in specified geographic areas to "catch-up" and pay for appropriate licenses without the payment of damages. For more information on the BSA, you can visit its website located at *www.bsa.org*.

If you conduct an internal audit of your company's software and discover unlicensed copies, we recommend that you seek the advice of legal counsel experienced in this area before any action is taken.

Now, does your company have a policy against software piracy? An essential part of any company software management program is the establishment of a software policy that governs the purchase and use of third party software by the company. A software policy educates management and employees on the "do's and don'ts" of company licensed software. A software policy that prohibits unauthorized copying, use and installation of software on the company's computers can help insulate the company against liability for intentional copyright infringement.

The do's: (1) appoint a designated person or unit responsible for the establishment of a Software Policy Statement, the purchase of software and the review of software license terms; (2) require all employees to sign a copy of the Software Policy Statement acknowledging that they have read and understand it; (3) require all purchases be made from reputable sources, in writing and authorized by the designated person or unit; (4) maintain a central location for the safekeeping of original licensed software, original manuals, purchase receipts, licenses, registration cards, etc.; (5) establish and publish a list of company authorized and supported software including the purchase, expiration and renewal dates and other special terms or restrictions pertaining to each license, and; (6) if you have a network license with a restricted number of users, install "metering" software that ensures against overuse of the licensed software.

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LABOR LAW

California Public Policy Prohibits The Imposition of a Forfeiture for Departing Employees Who Compete

By Lori A. Lutzker, Esq. and Elisë Clowes, Esq.

As a standard part of the hiring process, employers frequently require employees to sign agreements with clauses that may be buried in the "legalese." This occurs most often with Confidentiality Agreements, also called Proprietary Information, Nondisclosure or Trade Secret Agreements (referred to herein as "Confidentiality Agreements"). Problems may arise when a company uses a Confidentiality Agreement without first becoming familiar with the meaning and effect of all of the terms.

While most states allow employees to enter into legal non-compete agreements if the agreements are reasonable in scope and duration, California does not. California Business and Professions Code Section 16600 states "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void." Thus, contracts prohibiting a departing employee from competing with his or her former employer have been held unenforceable.

California law only permits the enforcement of non-compete agreements under narrow circumstances as part of a sale of a business in which the employee is selling all of his or her stock in the company. If an employee in California signs a non-compete agreement that does not fit into this narrow sale of business exception, the agreement is unenforceable.

D'Sa v. Playhut, Inc.

But there may be even more adverse results. Based on recent cases, an employee may recover damages from an employer by refusing to sign an unenforceable non-compete agreement. In D'Sa v. Playhut, Inc., a California appellate court ruled that an employer may not terminate an employee who refuses to sign an illegal covenant not to compete. The employer argued that the court should have struck the non-compete and upheld the remainder of the agreement.

"An employee may recover damages from an employer by refusing to sign an unenforceable non-compete agreement."

The court disagreed, stating that employees were unlikely to know that the covenant not to compete, buried in a long legal document, was illegal. The court stated, "We reject the concept that a worker, compelled by economic necessity to secure employment, can be thus coerced into signing sweeping agreements…in the uninformed hope the agreement will not be enforced by the courts."

Consistent with this view, courts have raised questions as to whether forfeiture provisions in employment contracts are valid. In International Business Machines Corporation v. Bajorek (9th Cir. 1999) 191 F.3d 1033, the Ninth Circuit held that a contract requiring a former employee to forfeit stock options upon becoming employed by a competitor was enforceable.

Walia v. Aetna, Inc.

On November 27, 2001, the Court of Appeal in the First Appellate District issued a decision in the case of Walia v. Aetna, Inc. In this case, Aetna terminated its employee, Anita Walia, when she refused to sign a non-competition agreement. The non-compete prevented employees, for a period of six months after departing from Aetna, from working for a competitor in the same state in which they had been employed by Aetna. When Walia refused to sign the agreement, Aetna terminated her.

At trial, the court found that the agreement violated Business and Professions Code section 16600 and the jury awarded Walia $54,312 in compensatory damages, $125,000 in emotional distress damages and $1,080,000 in punitive damages. Aetna appealed.

In the course of confirming that Aetna's non-compete agreement was unenforceable, the court noted that in Bajorek, the Ninth Circuit held that an agreement that required an employee who worked for a competitor within six months after leaving IBM to return stock options did not violate Section 16600. The court noted that although the Ninth Circuit seemed aware that California authority was contrary to its conclusion, it felt itself bound by prior interpretations of California law.

Muggill v. Reuben H. Donnelley, Corp.

The Aetna court found that the Bajorek decision was, in fact, contrary to California law because it is contradicted by the case of Muggill v. Reuben H. Donnelley, Corp. (1965) 62 Cal.2d 239. In Muggill, the California Supreme Court held that an agreement requiring an employee to forfeit pension rights if he went to work for a competitor "restrains him from engaging in a lawful business and is therefore void."

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Because the spousal rollover rules remain unchanged, the new rules really just apply to non-spouse beneficiaries (e.g., children) of an inherited IRA.

Under the new rules, post-death required distributions will be based on the designated beneficiaries in place as of *December 31 of the year following the year of the IRA owner's death*. Even if there is no designated beneficiary in place as of that time, distributions may still be deferred under one of the following rules:

1. If the IRA owner died *before* his or her *required beginning date*, distributions may be deferred for up to five years following his or her death; or

2. If the IRA owner died *after* his or her *required beginning date*, distributions may be deferred over his or her remaining life expectancy, based on the age that he or she attained or would have attained in the year of his or her death.

This latter change eliminates the "gotcha" effect under the old rules of failing to make the recalculation as of the IRA owner's *required beginning date*. Under the default provisions of the old rules, the IRA owner's life expectancy would have gone to zero in the year of his or her death. This meant that the IRA owner's non-spouse beneficiaries would have been required to withdraw 100% of the IRA balance by December 31 of the year following the year of the IRA owner's death. Moreover, failure to have a proper beneficiary designation in place as of the IRA owner's *required beginning date* would have resulted in the same consequences.

Another important benefit of the new rules is that the post-death minimum distribution rules are based on the identity of the beneficiaries in place as of December 31 of the year *following* the year of the IRA owner's death, thereby allowing for certain *post-mortem* planning to optimize the minimum distributions from an inherited IRA. However, the new rules do not permit the beneficiaries to be *changed* after the IRA owner's death, as some newspaper articles have incorrectly suggested. The persons or entities that the IRA owner had designated as of his or her death cannot be changed after death – those designations are set in stone. Certain post-death events, nevertheless, can affect how those beneficiaries will calculate their required minimum distributions.

For example, if an IRA owner designates multiple individual beneficiaries (e.g., several children) and the IRA is divided into separate subaccounts for each separate beneficiary by December 31 of the year following the IRA

"Under the new rules, post-death required distributions will be based on the designated beneficiaries in place as of December 31 of the year following the year of the IRA owner's death."

owner's death, then the required minimum distributions from each beneficiary's separate subaccount will be based solely on the life expectancy of that beneficiary. Under the old rules, if an IRA owner named multiple individual beneficiaries, then the required minimum distributions for all beneficiaries were based on the life expectancy of the oldest beneficiary. As a result, it was often suggested that an IRA owner split the IRA into multiple IRAs for each beneficiary before the IRA owner's death. The new rules permit this splitting to occur after the IRA owner's death.

This ability to do *post-mortem* planning also allows for the cure of what formerly may have been considered a "defective" beneficiary designation. For example, an IRA owner who designated a charity as the beneficiary of a portion of his or her IRA and children as to the balance would have been considered as having no designated beneficiary in place. Accordingly, if the IRA owner died after his or her *required beginning date*, the children would have been required to have their entire share of the IRA distributed to them by December 31 of the year following the year of the IRA owner's death.

The new rules state that so long as the charity's share of the IRA is distributed to the charity by December 31 of the year following the year of the IRA owner's death, then the charity will not be considered a designated beneficiary. The children will then be able to base their minimum distributions on their respective life expectancies (if the IRA is also divided into separate subaccounts for each child). Even if this *post-mortem* planning was not completed by December 31 of the year following the year of the IRA owner's death, the new rules would still permit the children to base their required minimum distributions on the life expectancy of the IRA owner based on his or her age in the year of death.

The new rules would also allow for "disclaimers" (an irrevocable renunciation by a beneficiary of his or her right to inherit from a deceased person) to be taken into account in determining post-death minimum distributions. For example, a child could disclaim his or her right to inherit his or her share of a parent's IRA. If, as a result of that disclaimer, the child's share of the IRA then passes to his or her children (i.e., the parent's grandchildren), and if the IRA is segregated into separate subaccounts by December 31 of the year following the year of the IRA owner's death, then the minimum

distributions from each grandchild's subaccount would be based on the life expectancy of that grandchild.

Unchanged Requirements

The new regulations, however, do not change any of the following rules:

1. The deadlines for commencement of the required minimum distributions – IRA owners must still begin taking annual minimum distributions by April 1 of the year following the year in which they reach age 70 1/2 – (the "*required beginning date*").

2. The date when persons (other than a surviving spouse) who inherit an IRA from a deceased IRA owner must begin taking annual distributions – by December 31 of the year following the year of the IRA owner's death.

3. The ability of a surviving spouse to "rollover" the IRA of a deceased owner into a new IRA in the spouse's own name – for married couples, this will remain the most tax-efficient way to dispose of an IRA upon the death of the first spouse to die.

Effective Dates of New Regulations

The new regulations went into effect for all IRA owners (and beneficiaries of inherited IRAs) on January 1, 2002. With respect to *traditional* IRAs (as opposed to 401(k)s, Keoghs, profit sharing and other types of qualified plans), the new rules permit, but do not require, IRA owners to use the rules for the 2001 calendar year. The new rules will *not* apply to 2001 required minimum distributions from 401(k)s, Keoghs, profit sharing and other types of qualified plans (other than traditional IRAs) *unless* the documents governing the plan are amended before the end of the year by adopting the model amendment to the new rules.

Chang H. Chae is a member of Carr, McClellan's Family Wealth & Tax Planning Group.

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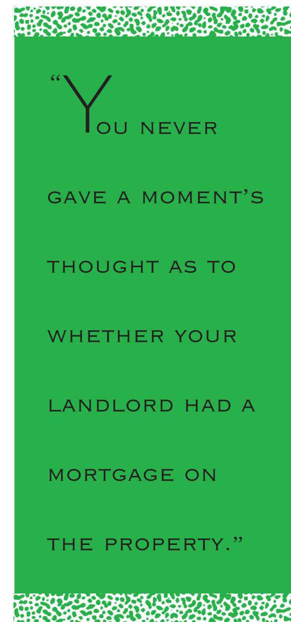


The Tenant and the Landlord's Lender

By Carol B. Schwartz, Esq.

A commercial lease is one of the most complex contracts most business people will ever enter into – one which can add value or result in a nightmare.

Imagine this scenario: Your business is flourishing. A few years ago you leased part of a building at 1001 Easy Street. The premises are perfectly suited to your business and, due to your exceptional foresight, you negotiated several options to extend the term of your lease to add expansion space, giving you the comfort you needed to focus on expanding your business.

You negotiated a very favorable rent structure with the landlord, so your fixed overhead costs are low relative to the marketplace. At the time, you never gave a moment's thought as to whether your landlord had a mortgage on the property. A few month's ago you heard rumors that your landlord had become delinquent in making his mortgage payment to Heartless Savings Bank (HSB). You didn't worry much about the landlord's misfortune because your lease says that it is binding on the landlord's successors and assigns.

Then, a letter arrives from HSB in the morning mail, notifying you that HSB has foreclosed its mortgage and is now your new landlord. Moreover, the letter says in bold print that HSB has elected to terminate your lease effective 30 days from your receipt of the letter.

How did this happen? When you look more closely at your lease it contains a "simple" statement that reads something like the following:

This Lease, at Lessor's option, shall be subordinate to any mortgage, deed of trust, or any other hypothecation or security now or hereafter placed upon the Premises and to any and all advances made on the security thereof and to all renewals, modifications, consolidations, replacements and extensions thereof. If any mortgagee or trustee shall elect to have this Lease prior to the lien of its mortgage or deed of trust and shall give written notice thereof to Lessee, this Lease shall be deemed prior to such mortgage or deed of trust, whether this Lease is dated prior to or subsequent to the date of said mortgage or deed of trust or the date of recording thereof.

Before HSB instituted foreclosure proceedings, it evaluated the rent stream generated by the Easy Street property and discovered that some of the leases were yielding below-market rates, while others were at or above-market. Because your lease was entered into *after* HSB's mortgage was recorded against Easy Street, the lease is "subordinate" to the mortgage. Whether a lease is "subordinate" or "prior" normally depends on the date of the lease compared to the date of the mortgage. The order of priority can be changed, however, by written agreement between the lender and the tenant. Recording laws may also have an effect.

When HSB foreclosed, its title to the property relates back to the time its mortgage was recorded. Any encumbrance, such as your lease (which is junior to the mortgage being foreclosed), is described as being "cut off" by the foreclosure. This means that HSB acquires the Easy Street property free and clear of any "subordinate" matters – in this case, your lease! The same would be true if a third-party purchased the property at HSB's foreclosure sale, because the foreclosure-sale purchaser stands in the shoes of the foreclosing lender.

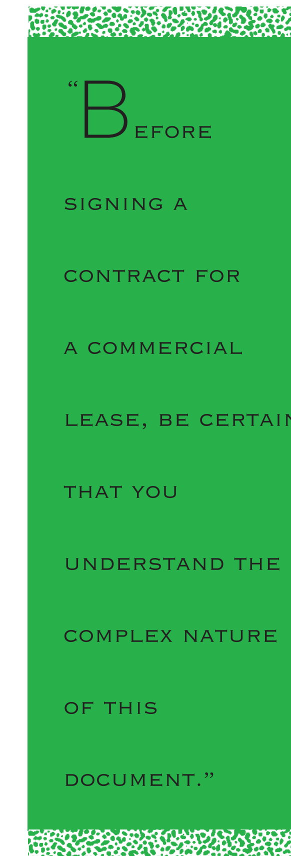
If your lease had been "senior" to the mortgage because it was entered into before the mortgage was recorded, the lease still permitted HSB to unilaterally subordinate the lease to the mortgage simply by giving you notice of its decision. If the lender did not want to "cut off" your lease, HSB could have sent you a notice confirming that your lease was to be deemed "prior" to its mortgage.

In other words, the lender retains the ability to pick and choose which leases will be terminated or "cut off" by a foreclosure.

Even the "boilerplate" has an economic impact. While economic terms – base rent, rent adjustments, term, options to extend or expand – naturally drew the focus of you and the landlord when you negotiated a lease of commercial space, you now realize how important it is to comprehend the so-called "boilerplate" portions of the lease.

As the HSB scenario dramatizes, it is also important to understand the concepts of "attornment" and "subordination" and what is referred to in the trade as a "Subordination, Non-Disturbance and Attornment Agreement" or the SNDA.

What is an SNDA? It is an agreement entered into between a landlord, its tenant and the landlord's *lender prior to or concurrently with the lease* that specifies the rights and obligations of a lender (or foreclosure-sale purchaser) after a foreclosure sale or a deed in lieu of foreclosure. Although some pitfalls exist in blindly executing an SNDA, the SNDA can be a great benefit to the tenant.



Prior to making a loan on commercial and rental property such as 1001 Easy Street, most lenders require that its borrower obtain an SNDA (which is signed by the lender as well as the landlord and tenant) from each tenant. The SNDA provides for:

- the tenant to subordinate its rights as tenant to the rights of the lender under the deed of trust or mortgage – in other words, to give up any priority the tenant may have over the lender (called subordination);
- the lender to not disturb the tenant's possession of the premises following foreclosure as long as the tenant is not in default (called nondisturbance); and
- the tenant to accept the foreclosure-sale purchaser as its landlord and to pay the rent to the foreclosure-sale purchaser (called attornment).

Sophisticated lenders often try to use the SNDA to "amend" the lease to limit the lender's liabilities should the lender step into the shoes of the landlord by eliminating (i) any liability for return of a tenant's security deposit, (ii) any obligation to construct improvements, (iii) any obligation to restore the property if there is damage or destruction, (iv) personal liability as successor to the landlord's interest in the lease (requiring the tenant to look solely to the lender's interest in the property as a source of recovery for any judgment against the lender as landlord), (v) any right of offset or defense which the tenant might have had against any prior landlord, and (vi) the enforceability against the lender of any amendment, modification, surrender or cancellation of the lease unless consented to in writing by the lender.

What is the moral of this tale of woe? Before signing a contract for a commercial lease, be certain that you understand the complex nature of this document. Entering into it with your eyes open can result in a contract that adds value to your business; not doing so may result in a nightmare similar to the scenario involving Easy Street and Heartless Savings Bank.

One additional note, in a "down economy," a tenant whose lease has become uneconomical and whose lease is junior to deed of trust recorded against the leased property and who has *not* signed an attornment agreement with the landlord's lender may receive an unintended windfall – the right to walk away from the lease. This is because, absent an agreement to the contrary, a lease that is *junior* to a deed of trust recorded against the leased property will be terminated by the foreclosure of the senior deed of trust, thereby freeing the tenant from lease obligations.

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