

IN THE SPOTLIGHT

Landlords and Tenants Mediate Conflicts

By David Garcia

Financial security has become a two-way street. Prudent landlords have always scrutinized prospective tenants for financial security. But in recent years, it has become equally commonplace for tenants to scrutinize their landlords for financial security. Nevertheless, these are unusual economic times. The rise in loan delinquency rates has led to a wave of foreclosures.

Tenants looking for commercial space are seeking to avoid leases with landlords that leave them at risk of losing that space, or that put at risk landlords' ability to provide contracted services or complete promised improvements. Tenants recognizing that this may be impossible to accomplish in these volatile economic times may seek to protect themselves by negotiating appropriate lease provisions.

More at risk are tenants who are operating under lease provisions not negotiated in anticipation of unstable economic conditions. Some of those tenants are the beneficiaries of provident negotiations. Others are not, and related conflicts can often result in explosive litigation. Mediation offers an efficient and cost-effective means to resolve disputes between parties including tenants, landlords, successor landlords or purchasers at foreclosure sales.

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FORECLOSURES IN COMMERCIAL REALTY STRESS LANDLORD-TENANT RELATIONS

Lenders and successor landlords, as well as landlords that are intent on forestalling foreclosure, all have significant incentive to avoid foreclosure and to maintain as stable a relationship with existing tenants, if it does occur, as economic circumstances require and permit. Consequently, lenders are deferring foreclosure, creating incentive for landlords to seek to renegotiate lease obligations they are having difficulty fulfilling. Moreover, when foreclosure occurs, foreclosing purchasers are motivated to negotiate new leases with existing tenants that will guarantee income flow.

Whether or not tenants have protective lease provisions, conflicts frequently arise with landlords facing economic stresses, and more often arise with the successor landlord, foreclosure purchaser. These conflicts threaten — and often result in — litigation.

Before discussing how mediation can assist in the resolution of such disputes, a brief review of standard protective lease provisions and general legal principles related to foreclosures is useful.

PROTECTIVE LEASE PROVISIONS

Commercial property tenants often seek guarantees that their landlord will fulfill its obligations. For example, where the landlord is a thinly capitalized entity, or where there is otherwise concern about the landlord's financial stability, or simply as a concession to the prudent tenant, tenants insist on landlord guarantees to secure completion of the landlord's construction or improvement obligations, reimbursement of tenant construction or improvement contributions, or other concessions the landlord has given as an inducement toward execution of the lease.

The tenants protect themselves by requiring the landlord to put funds up front in an escrow account to ensure a source from which to satisfy the landlord's obligations

for lease concessions. Alternatively, tenants include a provision in the lease giving the tenant a right of offset for sums owed by the landlord (plus interest thereon) against sums owed by the tenant under the lease.

Most commonly, to protect against foreclosure, tenants insist on appropriate "non-disturbance agreements" with third parties holding senior liens (e.g., a trust deed) on the property (thus ensuring that the tenant's leasehold interest will not be affected by foreclosure or other adverse action against the landlord's interest).

Ordinarily, a successor in interest remains bound by all the terms and conditions in the lease. The sale or assignment ordinarily transfers all of the original landlord's rights and remedies under the lease. This includes the right to sue for the recovery of post-transfer accruing rent and the right to terminate the lease or otherwise sue for breach of any other covenant in the lease. This article will use California law to illustrate the discussion. *See, e.g.*, California Civil Code Section 821. The tenant, in turn, becomes a tenant of the landlord's successor, obligated to the successor under all of the tenant covenants in the lease. The tenant has the same rights and remedies to enforce the original landlord's covenants against the successor, e.g., California Civil Code Section 823.

NONJUDICIAL FORECLOSURE DESTROYS JUNIOR INTERESTS

A nonjudicial foreclosure ("trustee's") sale, however, conveys to the purchaser absolute title that "relates back" to the date on which the trust deed was recorded. All subordinate liens and encumbrances, including junior leasehold interests (those created after the deed of trust), are extinguished. *See, e.g.*, California Civil Code sections 2924 *et seq.* *Principal Mut. Life Ins. Co. v. Vars, Pave, McCord & Freedman* (1998) 65 Cal.App.4th 1469, 1478, 77 Cal.Rptr.2d 479, 484. The same rule applies to subsequent amendments of preexisting (senior) leases. Subse-

quent amendments are subordinated to the prior lien of the deed of trust and are extinguished by nonjudicial foreclosure. *In re 240 North Brand Partners, Ltd.* (9th Cir. BAP 1996) 200 B.R. 653, 660.

Because the foreclosure sale effectively destroys subordinate leasehold interests, the foreclosure purchaser may treat the tenants as occupants without rights, subject to immediate eviction. California Code of Civil Procedure Section 1161a. Conversely, tenants have no further obligations under their leases and may vacate. If the tenant under a lease extinguished by foreclosure continues in occupancy after the sale, paying monthly rent to the purchaser, a new month-to-month tenancy is created, terminable by either party giving 30-day notice. *Dover Mobile Estates v. Fiber Form Products, Inc.*, *supra*, 220 Cal.App.3d at 1498-1500, 270 Cal.Rptr. at 185-187.

Moreover, a senior lease may be deemed subordinate to an otherwise junior trust deed through a subordination agreement. Some leases include "automatic subordination" provisions, under which the tenant agrees that its lease will become subordinate to any after-created liens or encumbrances on the landlord's property. *Principal Mut. Life Ins. Co. v. Vars, Pave, McCord & Freedman*, *supra*, 65 Cal.App.4th at 1479, 77 Cal.Rptr.2d at 484.

NONDISTURBANCE AND ATTORNMENT AGREEMENTS

To protect against the risk of losing their leases through foreclosure, subordinating tenants often negotiate with the landlord to obtain a nondisturbance agreement from future lenders; thereby, foreclosing senior lienholders agree not to disturb the junior tenants' possession so long as the tenants have not defaulted on their leases. *Principal Mut. Life Ins. Co. v. Vars, Pave, McCord & Freedman*, *supra*, 65 Cal.App.4th at 1479, 77 Cal.Rptr.2d at 484.

An attornment agreement also addresses the parties' relationship and rights in a foreclosure situation. Under such a provision, the tenant agrees to recognize ("attorn to") the landlord's successor in interest (foreclosing purchaser) as its new landlord. *Principal Mut. Life Ins. Co. v. Vars, Pave, McCord & Freedman*, *supra*, 65 Cal.App.4th at 1479, 1483, 77 Cal.Rptr.2d at 484-485, 487. When a lease obligates a tenant to "attorn to" a new landlord in the event of foreclosure by a senior encumbrancer, the terms of the attornment provision govern how that will occur and its effect on the existing lease.

Successor landlords are motivated to recognize leases with tenants who have attorned to the new landlord. Nevertheless, the current economic conditions motivate landlords to seek beneficial amendments and create conflict.

JUDICIAL FORECLOSURE SALES DO NOT AUTOMATICALLY EXTINGUISH JUNIOR LEASES

In contrast, a judicial foreclosure sale does not automatically extinguish junior leasehold encumbrances. Rather, the trust deed beneficiary has the opportunity to elect which junior leases it wishes to wipe out through foreclosure by naming those encumbrancers in the foreclosure lawsuit. Junior encumbrancers not named in the suit are not affected by the foreclosure decree. California Code of Civil Procedure Section 725a; *Chumash Hill Properties, Inc. v. Peram* (1995) 39 Cal.App.4th 1226, 1228-1230, 46 Cal.Rptr.2d 366, 367.

MEDIATION AND EARLY NEUTRAL EVALUATION RESOLVE RESULTING CONFLICTS

Regardless of the efforts made to provide protections in a lease, often because of the existence of protective provisions, conflicts ensue. Tenants with nondisturbance agreements often face eviction (unlawful detainer actions) following a foreclosure sale after the landlord owner's trust deed default.

In the current economic times, landlord disputes commonly occur over maintenance and repair obligations, completion of tenant improvements, credits and offsets, and renegotiation of lease terms. Conflicts may include third parties, such as contractors and their subcontractors, the landlord, the tenant, and sometimes the lender or lenders. Whether litigation has occurred or is threatened, mediation provides an opportunity to resolve disputes effectively.

Mediation is a confidential, non-binding process whereby a neutral third party assists the parties to reach a mutually beneficial resolution of their dispute. Often it is voluntary, though it can be court ordered. Unlike litigation, where a judge or jury imposes a decision on the parties, the parties retain control of the resolution. They decide whether and on what terms they will settle. Parties own the settlement.

The mediator assists the parties to reach agreement by helping the parties to identify all of their issues and interests, to explore the risks and consequences of not settling, and to understand the strengths and weaknesses of their positions (legally and pragmatically). Mediation helps the parties to understand the potential benefits from settling and encourages parties to reach accommodation where accommodation is in their best interest. Ultimately, mediation explores and encourages optimal, pragmatic, realistic, and economic resolution.

The mediation may commence with pre-mediation telephonic conferences, usually a joint conference with counsel for all parties to discuss logistics, such as briefing,

exchange of briefs, necessary attendees, whether to commence the formal mediation with a joint session. The joint telephonic conference may be followed up by private telephonic conferences where counsel can address sensitive issues.

The formal mediation session may commence with a joint session, either a simple introduction or more formal presentation of positions, or with private caucuses between the mediator and each party. During the private caucuses the parties are encouraged to share information that the parties do not wish to share with the other sides. These caucuses provide an opportunity for the parties to assess pragmatic solutions. The caucuses continue until a settlement solution acceptable to all parties is reached.

The parties then write and execute a memorandum reciting the terms of the agreement. Because of the complexity of commercial lease negotiations, a formal agreement and all necessary supplemental documents, including all of the required terms can be prepared later. The mediator may be appointed to resolve expeditiously disputes regarding documentation necessary to effectuate the settlement. But given the collaborative nature and the interest in continuing relationships, drafting the formal documents is generally not problematic.

Early neutral evaluation (a mini-trial) can also be used in conjunction with mediation. It is an effective method for resolving disputes when combined with mediation. The neutral receives briefs in advance of the hearing, and listens to the proffered case including informal statements by the parties with strict time limitations, then makes an assessment of the cases and defenses.

Sometimes where the issues are exclusively legal and not factual, the parties can elect to submit the briefs for a non-binding evaluation as if the briefs were for summary judgment (without the formality). In advance of receiving or following the evaluation, the parties can agree to go forward with mediation with the evaluating neutral or another neutral. The evaluation is non-binding and confidential as are all briefs and submissions.

CONCLUSION

Mediation should be considered to avoid litigation and work out solutions between tenants and landlords, successor landlords (including foreclosing lenders), or purchasers at foreclosure sales. This is a low-cost solution that is more pertinent than ever in lean economic times.