MILLER STARR REGALIA

DEVELOPMENTS

FALL 2008

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Get it on the CALENDAR

UPCOMING MILLER STARR REGALIA EVENTS

- **1.23.09** - CEB Program: Real Property Law Practice
  Sacramento, California
- **3.3.09 - 3.5.09** - ICSC Monterey Idea Exchange
  Monterey, California

RECENT AND UPCOMING ARTICLES

- "*Anti-SLAPP Statute in the Real Estate Litigation Mix*"
  By Matthew Henderson, October 2008, *California Real Estate Journal*
- "*Current Issues in General Lease Financing*"
  By Karl Geier, January 2009, *Commercial Mortgage Insight Magazine*
- "*Avoiding Problematic Acquisitions Through Comprehensive Due Diligence*"
  By Sidney Fohrman and Kristina Lawson, March/April 2009, *Commercial Investment Real Estate Magazine*

STEPHEN J. FOWLER: NEW ADDITION TO MILLER STARR REGALIA

Stephen J. Fowler has joined Miller Starr Regalia as a shareholder. Mr. Fowler has more than 20 years experience in connection with complex construction and civil litigation. His extensive experience includes representing owners, contractors, engineers, material suppliers, and product manufacturers. That representation includes both public and private construction projects, hospitals, airports, power plants, manufacturing plants, rapid transit, oil refineries, commercial building, high-end private residences, and multi-unit housing developments.

Mr. Fowler has co-authored a treatise on *California Construction Law*, published by Federal Publications Seminars LLC. Additionally, he authored the "California Construction Law" chapter of the *State Public Construction Law Sourcebook*, published by CCH (2002). He also regularly presents on various topics, including document preservation, production issues and electronic discovery in complex litigation.

What Commercial Landlords need to know When Their Tenants File Bankruptcy

By Robin M. Pearson

During these difficult economic times when many businesses are struggling, there has been a steady increase in the number of bankruptcy filings by commercial tenants. Commercial landlords need to be informed of their rights and obligations created by the Bankruptcy Code. This is especially true because of the amendments to the Bankruptcy Code passed in 2005 that changed the protections available to landlords. This article provides a summary of some of the important issues facing commercial landlords who seek to minimize the risks when their tenants file for bankruptcy.

Bankruptcy May Prevent Eviction

When a tenant files bankruptcy many landlords consider evicting their tenant to be a top priority. However, the bankruptcy filing actually prevents the landlord from evicting the tenant, at least in the short term for the reasons described below.

When a tenant files bankruptcy an automatic stay is created. It provides broad, instant protection from lawsuits, claims and collections that are already in progress when the bankruptcy is filed. All efforts against the debtor or against the property of the bankruptcy estate to collect on pre-petition debts or obligations (i.e., those arising before the bankruptcy was filed) are stopped and cannot be pursued without permission from the bankruptcy court. If the debtor is taking action that is creating an immediate harm for which relief from stay is needed, the creditor must make a motion to the bankruptcy court for that relief. Bankruptcy Code Section 362 (11 U.S.C. § 362). The penalties for violating the stay are substantial – actions taken are deemed void, and parties responsible can be held in contempt.

I. The Tenant's Options

After filing bankruptcy the tenant has three options: (1) To reject the lease, (2) assume or keep the lease or (3) assign the lease. Bankruptcy Code Section 365 governs the assumption, assignment and rejection of executory contracts. Unexpired leases are considered executory contracts. A bankrupt tenant has 120 days to decide what to do with the lease and then can ask the court for an additional extension up to 90 days. Bankruptcy Code § 365(d)(3) & (4). This provides the tenant 210 days or approximately seven months from filing bankruptcy as the amount of time a tenant can take to determine the fate of its lease. Once the 210-day period expires, the court has no power to grant further extensions unless agreed to by the landlord. The tenant must also remain current on its rent during the seven-month extension period.

A. If the Lease is Rejected

If a lease is priced over market, it is probable that the tenant will reject the lease. The tenant must notify the bankruptcy court and the landlord if it desires to reject a lease it views as unfavorable.

Once the court accepts the tenants decision, the tenant must surrender possession of the property and is no longer required to pay rent. Any unpaid rent outstanding at the time of surrender becomes an unsecured debt of the bankruptcy estate.

B. If the Lease is Assumed

A tenant may choose to keep a lease if it determines that the lease is important to its ongoing business. This is called "assuming" the lease. The tenant must seek approval from the bankruptcy court and cure any previously unsatisfied obligations under the lease and provide adequate assurance that it can promptly meet existing obligations.[1] The tenant must also demonstrate to the court that it can actually perform the lease obligations.

C. If the Lease is Assigned

If a lease is valued under market and is not critical to the tenant's ongoing business, the tenant may choose to assign the lease to a new party. In this situation the original tenant must seek approval from the bankruptcy court and satisfy all lease obligations, including the payment of past due obligations. In some instances the new tenant may be willing to satisfy the original tenant's past due obligations.

D. Shopping Center Landlords

Shopping center landlords have greater rights over new tenants to protect against being forced to accept an unfavorable tenant as a result of an assigned lease. This is known as an adequate assurance of future performance and requires the following: First, the new tenant must be at least as financially sound as the original tenant at the time the lease was originally signed. Second, the new tenant must show that the percentage of rent will not decline substantially. Third, the assignment may not violate any location, use, radius, or exclusivity provision of the lease, or any other leases, at the shopping center. Bankruptcy Code § 365(b)(3).

E. The Tenant Must Keep Paying Rent

A tenant is obligated to pay all of the rent and other charges due under the lease during the bankruptcy in exchange for the privilege of remaining in possession of the leased location. This obligation lasts for as long as the tenant remains in possession of the premises. Other than unpaid rent or charges that came due prior to the bankruptcy filing, the tenant is not required to cure the default to remain in possession of the property. Almost every right provided to the landlord by Bankruptcy Code § 365 can be waived by failure to assert the right in a timely way. This means that if the debtor moves to extend the time to assume or reject the lease and has not been paying rent, the landlord should file an objection and note the violation of the debtor's obligations to stay current with post-petition rent while the court makes its decision. Additionally, by way of example, if the debtor moves to assume and assign its coffee store lease to a dry cleaner, an objection must be filed and note that such an assignment would violate the use clause of the lease. Further, if the debtor moves to assume the lease and sets the cure amount at zero, the landlord should file an objection and insist that any pre-petition default should be cured when the lease is assumed.

II. Proactive and Pre-Bankruptcy Litigation Steps

Thus, it is important that the landlord take early action to protect against the difficulties and expense of dealing with a tenant in bankruptcy. Landlord should avoid being on the defensive and act early at the first sign of trouble.

- **PAST DUE RENT:** Landlords must be proactive in their management of tenants who are untimely in making their monthly rental payments. Prior to a bankruptcy filing, landlords can file a proper unlawful detainer complaint. If a tenant fails to pay rent, the landlord should serve the tenant with a three-day notice to pay rent or quit and immediately file an unlawful detainer complaint. If the landlord is able to file the complaint and complete the proceeding before the tenant files for bankruptcy, the lease is deemed terminated as a matter of law. The tenant no longer has rights under the lease, and the landlord can evict the tenant without being subject to bankruptcy laws which eliminates the problem described earlier in this article. Therefore, if a landlord suspects that a bankruptcy filing by a tenant may be imminent, acting promptly when rent is not paid timely may be the difference between obtaining immediate possession of the property or being subject to the bankruptcy court rules for a significant period of time.

- **SECURE BANKRUPTCY COUNSEL PROMPTLY:** Timing is a major factor in how landlords fair in tenant bankruptcy matters. Obtaining strategic professional bankruptcy counsel can be critical for landlords. In bankruptcy proceedings, tenants often obtain rights they otherwise would not have, rights that come at the expense of landlords, including certain rights landlords normally enjoy under state law. Acting before a bankruptcy filing occurs is the ideal scenario to protecting the rights of the landlord. However, if that is not a possibility, acting quickly when a bankruptcy does occur is the next best thing. Landlords should act promptly to help enforce their rights to receive current rent, to protect against an unwanted assumption or assignment, or when acting in a pre-bankruptcy setting to evict the tenant. Early intervention and retaining counsel are wise business moves for landlords in bankruptcy disputes with their tenants. Landlords who receive early stage bankruptcy counsel gain a definite advantage and are in a better position during bankruptcy court proceedings. These landlords can even minimize the legal expenses of managing the insolvency of their tenant.

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Slip Sliding Away

Court of Appeal Finds a Categorical Taking Imposed by City's Landslide Development Moratorium

By Ethan Friedman, Senior Counsel

The Second District Court of Appeal in Los Angles recently rendered its decision in *Monks v. City of Rancho Palos Verdes* (Oct. 1, 2008) 167 Cal.App.4th 263 ruling that the City's moratorium on construction in a landslide area was a taking since it denied the property owner of all economically beneficial use of their property. This is a major property rights decision and changes the landscape for takings law in California. That being said, it is expected that the case will be appealed to the State Supreme Court. However, for the time being, it is an important precedent supporting property rights in California.

The Monks and 15 other plaintiffs filed suit in July 2002 challenging the City's adoption of a resolution, which added limitations to the exceptions under which development could occur in a historic landslide area within the City. The plaintiffs are all owners of single-family residential zoned lots within Zone 2 of the City's Landslide Moratorium Area. The earlier City resolution, adopted in 1978, allowed property owners to obtain an exemption if they only could show that it was safe to build a home on their lot. The City's new resolution was based on findings that Zone 2 might have added risk for future slides and that the gross "factor of safety" for Zone 2 could not be determined. The City's new resolution, the one challenged in this suit, was adopted while the plaintiffs' applications for development under the original exemptions were pending.

A "factor of safety" is an equation comparing instability versus stability of future development in a slide prone area. Any factor greater than one means the development would be stable, a factor of less than one means the development would not be stable. As the Court explained, a factor of safety of 1.5 "means that the forces of stability are at least 50 percent greater than the forces that cause instability." It also accepted that "because a safety factor cannot be calculated with precision, a factor of at least 1.5 provides an important margin of error and is accepted as the standard factor of safety by geotechnical professionals for residential construction." The City's report supporting the amended resolution concluded that there was insufficient evidence that Zone 2 had a gross factor of safety greater than 1.5. The resolution modified the existing moratorium exemptions which had allowed development where the property owner could demonstrate that the local factor of safety – that is the factor of safety for the specific lot was greater than 1.5. The challenged resolution concluded: "Based on the foregoing, the City Council is directing City Staff to continue to deny requests for development permits for new homes in the Zone 2 area… because of the lack of evidence that the Zone 2 area has a factor of safety of 1.5 or greater, until an applicant submits a complete Landslide Moratorium Exclusion application that is supported by adequate geological data demonstrating a factor of safety of 1.5 or greater of the Zone 2 area to the satisfaction of the City Geologist…"

The plaintiffs' suit challenged the new moratorium's additional restrictions and the trial court limited the evidence on the plaintiffs' petition to the administrative record. The plaintiffs successfully appealed on those grounds and the court of appeal reversed and remanded to the trial court ordering a new trial, allowing evidence outside of the administrative record. A trial followed, and "[t]he trial court concluded that permanent taking had not occurred, finding that the city had acted with proper authority in imposing the moratorium and passing the [new] resolution" requiring applicants to show a *localized* factor of safety of greater than 1.5. Plaintiffs again appealed.

The new trial was a battle of experts, a battle explored and dissected by the Court of Appeal over nine pages of its decision. There was conflicting testimony at trial about the extent, severity and location of landslides in Zone 2, and the trial court ruled in favor of the City again on plaintiffs' taking claims, concluding that "at best there remains uncertainty with respect to the stability of the geology of Zone 2 and the surrounding areas…" The trial court also noted that litigation involving development in nearby zones had cost the City a significant amount of money and that "a public entity is not required to risk bankruptcy" to satisfy the "unsubstantiated beliefs" of a handful of property owners. Ultimately, the trial court's rejection of plaintiffs' taking claim was based on state

nuisance law – that development in Zone 2 was "a substantial and reasonable interference with collective social interests."

The Court of Appeal made an exhaustive review of takings law and state nuisance law. In particular, the Court focused on the Supreme Court decision of *Lucas v. South Carolina Coastal Council* (1992) 505 U.S. 1003. *Lucas* involved a challenge by a beachfront property owner whose lots were on the seaward side of a State beachfront management plan (to prevent future erosion) and thus precluded from development. *Lucas* stands for the proposition that the government may not exact a regulation on land that denies the owner "all economically beneficial uses in the name of the common good." If a regulation causes such a result, there has been a taking. *Lucas* also held that the Legislature cannot impose laws finding a need for the regulation – but that "the State's law of property and nuisance" must already limit the owner's proposed uses. In other words, the law can do more than could have been accomplished by adjoining landowners through litigation. Moreover, where there is a categorical regulatory taking, the government bears the burden of proving that the intended use is not permitted under state law.

Applying *Lucas*, the Court of Appeal found that there was a categorical, or per se, taking of the plaintiffs' land. The Court of Appeal was convinced that no administrative process or repeated applications would result in any different result and that the new resolution is a denial of all economically beneficial uses.

Once it made this finding, the Court of Appeal analyzed "whether the moratorium is justified by state principles of nuisance or contract law." In other words, it must determine whether the construction of homes on plaintiffs' lots posed "a significant harm to persons or property" and therefore constituted a public or private nuisance. This determination required the City to essentially "show that, under common law nuisance principles, it could obtain an injunction against the construction of homes on plaintiffs' lots." The Court of Appeal determined that construction of the homes did not constitute any type of nuisance.

First, it found that there is nothing inherently harmful about plaintiffs' planned use of the properties consistent with the City's zoning. The Court noted that the City had even provided requisite utilities for the zoned residential use. The Court of Appeal agreed with the trial court's assessment that there was "uncertainty" with respect to stability, but unequivocally held that "uncertainty is not a sufficient basis for depriving a property owner of a home." In order to obtain an injunction, the City would be required to demonstrate a reasonable probability of harm and uncertainty does not rise to that level.

The Court also found that there was limited risk to property or persons in allowing development. The Court also dismissed the City's building code regulations requiring a 1.5 factor of safety for residential development, holding that "[t]he risk of property damage and personal injury… is not sufficient in any practical sense to justify applying the moratorium to plaintiffs' lots." In a final note, the Court of Appeal addressed the trial court's discussion of the potential costs to the City in future lawsuits arising from landslides in Zone 2 if development were allowed. The Court of Appeal found these suits to be entirely speculative and did "not justify violating the state Constitution and depriving plaintiffs' land of all economically beneficial use."

This decision may come as a surprise to many Californians during a period of increased skepticism over the government's power of eminent domain. It serves as a timely reminder that there are limitations on the government's ability to regulate land use and also that California courts are aware of those limits. It is likely that the City will petition the State Supreme Court for review, so we should watch this case closely. We should expect the decision to be upheld, but the story of this case may not end before it gets to the United States Supreme Court. This case may present the high court with an opportunity to further illustrate the limits on the government's ability to regulate private property. We shall see.

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California landlords need to know their rights and be ready to exercise protections that reduce their risk in tenant bankruptcies. Commercial landlords need not be victims when their tenants file for bankruptcy. Within the tenants bankruptcy case, pro-active landlords can take steps to collect post-petition rents, preclude assignments of their leases and, under certain circumstances, even evict their debtor/tenants. The Bankruptcy Code provides protection for commercial landlords, not just tenants. The key is understanding your rights.

[1] This includes any contractually required attorneys' fees incurred by the landlord, with the exception of attorneys' fees incurred in bankruptcy court litigation.

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On March 14, 2008, the Department of Housing and Urban Development (HUD) released its proposed rule to amend the existing regulations of the Real Estate Settlement Procedures Act (RESPA).[1] HUD's goal is to simplify and improve the disclosure requirements for mortgage settlement costs and to protect consumers from unnecessarily high settlement costs. While few question the desirability of the goals, many question the effectiveness of the proposed rule to accomplish them. This article discusses the wisdom of the proposed rule's Closing Script.

PURPOSE FOR THE CLOSING SCRIPT

One of the corner pins of the proposed rule is the requirement that the settlement agent (in California, the escrow agent) read to the consumer a Closing Script at the time of closing. The Closing Script is designed to (i) provide the consumer with specific information about the terms of the loan and (ii) provide a comparison of closing costs set forth in the Good Faith Estimate (GFE) and the HUD-1 settlement statement. The goal is to ensure that the consumer understands the principal terms of his or her loan, as well as variances between the estimated settlement costs and the actual settlement costs. But the method chosen creates serious problems for the title industry and other segments of the market.

SHOULD THE CLOSING SCRIPT BE PROVIDED TO THE CONSUMER BEFORE THE CLOSING?

The Closing Script is intended to be read to the consumer at the closing. But, if the intent is to provide greater transparency and understanding, the consumer should be provided a written form of the Closing Script in advance of the closing. The sooner script is provided, the sooner the consumer can receive the information and have the opportunity to act on the information, without the voluminous documents and pressures inherent with the closing.[2]

HOW WILL THE CLOSING SCRIPT BE PREPARED?

The Closing Script is designed to be attached as a new addendum to the HUD-1. Regardless of who prepares the Closing Script, there will be a significant cost to develop the computer software to prepare the Closing Script. The software will need to extract the central loan terms from the lender's computer as well as the closing costs reflected on the GFE. In addition, the software will need to extract the closing costs from the HUD-1 and generate the variance report called for by the proposed rule. Such software will likely need to be interactive with computer software of the escrow, adding even greater complexity and cost. Even HUD recognizes that it will be costly to develop the necessary software. Who should bear this cost and how these costs will impact the ability of smaller companies to compete in the marketplace raise serious questions.

WHO SHOULD PREPARE THE CLOSING SCRIPT?

The obligation to prepare the Closing Script rests on the settlement agent. But it is the lender that knows the principal terms of the loan. It is the lender that knows what information was disclosed to the borrower on the GFE. It is the lender that knows the respective variation between costs set forth on the GFE and the HUD-1, which are permissible under the proposed regulation. Accordingly, it is the lender who is in the best position to ensure the accuracy of the information on the Closing Script and should shoulder that responsibility.

Positing this obligation not only increases the cost of the escrow but significantly increases the potential liability of the escrow. Under existing laws, the duty of an escrow is to follow the instructions that it receives. While some escrow officers may be capable of reviewing loan documentation and retrieving all of the important information (including interest rate information which could be fixed, adjustable, adjustable with discounts, self-amortizing, etc.) and late fees and penalties, most do not presently have that type of training. Accordingly, positing the responsibility on the escrow will increase the likelihood of improper or confusing disclosures, unnecessarily expand the duties of the escrow and subject the escrow to unnecessary liability. It may also require the escrow to become involved in

A New Closing Script for RESPA Reform

By Richard Carlston, Shareholder

the unauthorized practice of law. If the escrow is to review the loan documentation, interpret the documentation, extract the principal terms, discuss them, address ambiguities, and answer questions, it can easily be argued that the escrow officer is engaged in the unauthorized practice of law.

It is clear that the proposed regulation, as currently proposed, would significantly change the role of the escrow.

IS THE PROPOSED VERBAL PRESENTATION OF THE CLOSING SCRIPT AT THE CLOSE OF ESCROW DESIRABLE?

The proposed rule contemplates that the Closing Script will be read to the borrower at the time of the closing. There are several problems with this proposed requirement. The first and most obvious one is that waiting until the last minute does not facilitate consumer choice. In fact, a common complaint of consumers is the pressure associated with the closing, the volume of documents and the risk of losing their deal if concerns or complaints are registered at the time of the closing. Indeed, by closing with an improper variance, a consumer may be limiting his or her remedy. Requiring the disclosure in writing in advance of the closing would protect the consumer and facilitate consumer understanding.

This approach does not reflect the reality of our closing marketplace. In California, and most states using escrows, escrows are not generally closed with a face-to-face meeting. Rather the parties to the escrow generally go to the escrow office to sign their documents in advance of the closing, which takes place later without either party being present. Also, there are a large number of escrows where a party does not even go to the escrow office but signs their documents in the comfort of their home or office with the assistance of an approved third party signing service. Finally, there are Internet escrows that incorporate e-signatures. Under each of these formats, the marketplace does not contemplate a face-to-face closing, let alone the verbal reading of the Closing Script at the close.

USE OF THE CLOSING SCRIPT AS PROPOSED WILL DELAY CLOSINGS

HUD recognizes that requiring the escrow officer to read the Closing Script will take some time and delay the closing. HUD estimates that the amount of additional time will only be approximately 15 minutes. But in determining its estimate, HUD has failed to include sufficient time for consumer questions. Depending on the inquiry, the prudent escrow officer will need to contact the lender for the requested information. This takes time. Depending on the nature of the inquiry and the availability of the appropriate loan officer this may take hours. If the closing is happening at the end of the day it may need to be delayed until the next day. If the lender is not available, the consumer will be presented with the choice of closing the escrow without having received the answer or delaying the close until contact can be established with the lender and the answer retrieved.

CONCLUSION

Currently HUD is evaluating each of the foregoing concerns. Ideally HUD will further amend the proposed rule to require the lender to prepare the Closing Script, provide it in written form a reasonable time in advance of the closing and answer the consumers' questions.[3]

[1] 73 Fed. Reg. 14030 *et seq*.

[2] Given that variance information is included in the Closing Script, average valuations will need to be provided for some of the cost elements whose exact amount is not known until the closing, such as recording fees.

[3] *See*, 5/13/08 Comment letter of the American Land Title Association; 6/5/08 Comment letter of the California Land Title Association; 6/10/08 National Association of Insurance Commissioners (Concurs with reading at closing but suggests prior written presentation to consumers; 6/11/08 Comments of the Federal Trade Commission; 6/13/08 Comment letter of the Federal Reserve System (suggesting further testing and noting practical difficulties with the script); 6/11/08 Comment letter of the Small Business Administration.

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NEWS that's fit to print

Miller Starr Regalia is pleased to announce the promotion of four new shareholders and one senior counsel effective January 1, 2009. The new shareholders are Kristina Lawson, Tara Castro Narayanan, William "Fritz" Pahland and Dana Tsubota. Ethan Friedman has been elevated to Senior Counsel.

LAND USE/ ENVIRONMENTAL

KRISTINA LAWSON

LITIGATION

TARA CASTRO NARAYANAN

LITIGATION

WILLIAM "FRITZ" PAHLAND

LITIGATION

DANA TSUBOTA

LITIGATION

ETHAN FRIEDMAN