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# Leasing and Loaning but Losing Track of the Difference

Roger Bernhardt

Golden Gate University School of Law, [rbernhardt@ggu.edu](mailto:rbernhardt@ggu.edu)

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MIDCOURSE CORRECTION

Leasing and Loaning but Losing Track of the Difference

ROGER BERNHARDT

*Vallely Investments, L.P. v BancAmerica Commercial Corp.* (2001) 88 CA4th 816, 106 CR2d 689, reported in this issue at p 201, demonstrates that knowing a lot about mortgage law won't make up for forgetting some elementary principles of landlord-tenant law. As a leasehold mortgagee intending to foreclose, the bank obviously put a good deal of thought into how best to work out matters with its trustor-borrower as far as the mortgage was concerned. But it failed to appreciate that its debtor was a tenant on a lease as well as a trustor on its deed of trust, and that the lease had seniority over the mortgage.

The terms of the lease reflected thoughtful bargaining by the parties. The tenant (Balboa) apparently intended to borrow money later on the security of its leasehold and wanted to do so on terms as favorable as possible. The landlord (Vallely) apparently was willing to cooperate by permitting any leasehold mortgagee to foreclose without having to assume any liability under the lease, as long as all other assignees did assume. Balboa probably anticipated that transferees planning to operate under the lease would not object to assuming the leasehold obligations, but also knew that a mortgage lender is averse to any downside feature in a loan and would not want to carry a liability (such as the obligation to pay rent) on its books after foreclosing. This arrangement made good sense for both of them.

The planning would have paid off if the bank, as leasehold mortgagee, had not mishandled Balboa's default by having Balboa assign the lease to a bank-related auxiliary (BACC), which both accepted the assignment *and* assumed the lease obligation. The facts show that Balboa was sinking and willing to cooperate, but that the existence of junior liens made a deed in lieu of foreclosure unattractive. (Mechanics' lienors are probably hard to negotiate with.) Considerations like that justify a decision to foreclose the mortgage, but they do not also argue for having the leasehold assigned in the meanwhile. Junior lienors are eliminated as effectively and speedily by a foreclosure on the original tenant as by one on the assignee.

I assume the bank required the assignment because it wanted to control the property during the foreclosure proceedings. A receivership, however, would have accomplished that as well as an assignment, especially if the appointment was not going to be contested. As of 1996, a mere demand on the operating tenants for rents under CC §2938 would have sufficed, but even before 1996, standard clauses in all deeds of trust permitted the beneficiary to demand rents or possession on default, and a borrower willing to assign the lease for the lender's sake seems equally likely to be willing to honor a demand for rent. In fact, since 1872, CC §2927 has explicitly permitted such an arrangement: "A mortgage does not entitle the mortgagee to the possession of the property, unless authorized by the express terms of the mortgage; but *after the execution of the mortgage the mortgagor may agree to such change of possession* without a new consideration." (Emphasis added.) Perhaps the bank wanted to avoid the status of being a "mortgagee in possession," although it is hard to know what it found wrong with that, given its willingness to accept an assignment arrangement. These possible alternatives—demanding the

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ROGER BERNHARDT is the Editor of the Reporter. He is a Professor of Law at Golden Gate University. In this column he considers the practical implications of recent developments in the real property area.

rents under the deed of trust, taking possession, or having a receiver appointed—certainly seem to make a lease assignment unnecessary.

The drawback of an assignment in this case was that the lease required it to be combined with an assumption. (If the bank intended to violate the lease terms in its workout arrangements, it would have been much better off to not assume than to assume and record but not tell the landlord, which makes me think that the failure to inform was a simple oversight.) Once there was an assumption, all of the advantage derived from the original leasehold mortgage provision was lost. A foreclosure would eliminate the mortgage on the leasehold, but it would not eliminate the leasehold itself or its attendant rent liability, which now burdened the assuming assignee as much as it had burdened the original tenant. As foreclosure purchaser, the bank was a lease assignee, but not an assuming one, because the original lease limited the bank's lease liability to privity of estate—*i.e.*, only so long as it remained a tenant. But the liability of its predecessor tenant (BACC) was not similarly limited. Thus, Vallely, the landlord, could go after BACC even though it could not go after the bank, when the ultimate tenant, Edgewater, failed to pay the rent.

A sublease may or may not have made a difference. In the court's paraphrase of the lease, the critical clause refers to "assignment" but not "sublease." While that may merely be shorthand, BACC's argument that this was a sublease rather than an assignment does suggest that it thought the distinction would make a difference. Perhaps the lease did limit the assumption requirement to assignments and not to subleases (although that seems unlikely), but if subtenants also had to assume, a sublease to an assuming BACC would have left it in the same situation. Subletting or assigning can make a difference, but not when both involve assuming.

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***"The mistake happened because the bank's lawyers were probably thinking more about foreclosure law than landlord-tenant law."***

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The mistake happened because the bank's lawyers were probably thinking more about foreclosure law than landlord-tenant law. In any event, the liability of an assuming assignee who is not in possession of the leased premises is somewhat counterintuitive. We so regularly tend to equate rent and possession that we often forget that a person can be liable for rent even when he is no longer entitled to possession. The original tenant who assigns her lease remains bound on her promise to pay rent for the entire term even after she is no longer the tenant; and the same is true for the assignee who assumes those terms as part of accepting the assignment of the leasehold. Ironically, landlords should insist that assignees assume, not to hold them liable on the lease covenants—they generally run with the land anyway, binding even nonassuming assignees—but to be able to hold those assignees liable if the second assignees default. This is not the case when the first assignee is obligated only by privity of estate rather than privity of contract; in that event, a second assignment by a prior nonassuming assignee terminates all future lease liability for him.

In this case there was a second assignee, Edgewater. We are not told whether it also assumed the lease (although it should have, since the lease provision exempting the leasehold mortgage did not seem to extend to the next post-foreclosure assignee). But because Edgewater then went into bankruptcy, it did not much matter whether it had assumed the lease or not: Neither the landlord nor the bank (as assignor, not as mortgagee) could get much from it. Nor did the assignee, BACC, have any recourse against Balboa as assignor, which had made the same promise to pay the rent as BACC. Vallely could have gone after Balboa for rent if it was unable to recover from BACC, but, between Balboa and BACC, ultimate rent liability should fall on BACC as the maker of the assumption promise rather than on Balboa as the receiver of the

promise. In any event, Balboa also went bankrupt, leaving BACC as the only solvent and liable party.

This lease still has 50 years to run. Edgewater rejected it in bankruptcy, but the lease itself is not dead as far as Valley and BACC are concerned. Since BACC continues to owe rent, the leasehold still exists; otherwise, the liability would be for damages rather than rent. The lease gives BACC the right to assign—and it better do so if it wants to minimize its liability. Of course, the lease also requires that the next assignee assume, but at least the parties' eyes should be wide open when they go through this again.