

11th Annual

Fundamentals of Landlord - Tenant Law

Sterling Education Services

**COLLECTIONS: HOW TO ENFORCE YOUR
JUDGMENT**

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DETERMINING COST VS. RECOVERY: IS IT WORTH IT?

Obtaining a judgment against a tenant and collecting on the judgment are two very distinct matters. In many cases, the goal is just to recover possession of the property, and the cost in seeking to collect on the judgment outweighs the actual judgment amount. For this reason, it is imperative to weigh the pros and cons of pursuing collection efforts.

In determining whether or not to pursue collections of a judgment, you need to consider the estimated cost versus the potential recovery.

Amount of the judgment. For example, if the landlord is pursuing eviction due to the end of the lease term, and there is no significant damage to the leased property, the main goal is usually possession. In this instance, the actual judgment amount is often minimal, and it may not be worth the time and expense to pursue collection. As a practice tip, it is recommended that the landlord at least issue a demand letter for payment of the judgment. Sometimes, the former tenant may surprise you and make the payment.

Assets of the former tenant. For example, if the landlord is certain the former tenant does not work, or has a low paying job, and does not have significant assets, it may not be beneficial to pursue collection of the judgment. If, however, the former tenant has a newer vehicle with no liens, then it may be worthwhile to pursue a levy on the vehicle. Similarly, if the landlord is aware that the former tenant or the co-signer on the lease has a good paying job, it may be advantageous for the landlord to pursue collection of the judgment through wage attachment.

The first avenue in the collection process is the security deposit.

1. Security Deposits.

Almost all leases provide for a deposit by the lessee as security for the payment of rent and/or for the lessee's performance of various obligations contained in the lease. The security deposit may be used by the landlord as security to be applied to the payment of accrued back rent if the lease provides for such application and/or any damages the landlord has suffered by the tenant's failure to comply with those terms and conditions in the lease.

- a. Security deposits for a rental agreement for residential property that is used as the dwelling of the tenant are governed by California *Civil Code* Section 1950.5.
 - i. Defined. A residential "security deposit" is defined by the Code as any advance payment of rent or any other payment, fee, deposit or charge, used or to be used by the landlord for any purpose, including, but not limited to:

- Compensation to the landlord for the tenant's default in payment of rent
 - Repairing damage to the premises (exclusive of ordinary wear and tear) caused by the tenant or by the tenant's guests or licensees
 - Cleaning the premises upon termination of the tenancy
 - If the rental agreement expressly so provides, remedying future tenant defaults in an obligation to restore, replace or return personal property or appurtenances (exclusive of ordinary wear and tear)
- ii. Limitations on amount of security. The amount of security that residential landlords may demand or collect is limited by the *Civil Code* Section 1950.5(c) and by local rent control regulations.
- First month's rent. Landlords may require payment of the first month's rent on or before initial occupancy as security.
 - Additional security. Landlords may also receive two months' advance rent as security if the unit is *unfurnished*, and three months' advance rent as security if the unit is *furnished*.
 - Additional security deposits for leases that are six months or longer. In long-terms leases of six months or more, advance payments of "not less than six months' rent" are permissible.
 - Alterations. Generally, no other "security" may be demanded or collected. However, landlord and tenant may agree to a specified fee for structural, decorative, furnishing, or other similar alterations, excluding repair of existing damage and ordinary cleaning necessitated by a previous tenant's occupancy.
 - Local restrictions. There may be additional limits under rent control ordinances that prohibit any increase in security deposits during the tenancy, or limit the amount of the security deposit for example to one month's rent.

iii. Limitations on retaining security at termination of tenancy. Amounts deemed “security” under the Code must be *held by the landlord for the tenant*. [Cal. Civ. Code § 1950.5(d)] Landlords do not have unlimited discretion to deal with the deposits as they please or to retain deposits when tenants vacate.

- Amount retainable – “nonrefundable fees” prohibited. No residential lease or rental agreement may contain a provision characterizing any security as “nonrefundable.” [Cal. Civ. Code § 1950.5(m)] Rather, residential security deposits may only be claimed by a landlord to the extent the Code expressly allows landlords to retain or use the deposit. [Cal. Civ. Code § 1950.5(e)]

A landlord may retain a security deposit for:

- 1) Compensate a landlord for a tenant’s default in the payment of rent, including rent due because of the tenant’s having given insufficient notice to terminate. [Cal. Civ. Code § 1950.5(b)(1)]
 - 2) Repair damage to the premises that was caused by the tenant or the tenant’s guests or licensees. Moreover, the security cannot be retained to remedy “ordinary wear and tear” during the tenant’s term, or to repair any damage or defective conditions that preexisted the tenancy. [Cal. Civ. Code § 1950.5(b)(2)]
 - 3) Cleaning the premises, but limited to returning the unit to the same level of cleanliness it was at the inception of the tenancy. [Cal. Civ. Code § 1950.5(b)(3)]
 - 4) Restore, replace or return personal property or appurtenances, but only to the extent that the rental agreement specifically authorized security to be applied for this purpose and only for “ordinary wear and tear.” [Cal. Civ. Code § 1950.5(b)(4)]
- Landlord’s creditors’ claims subordinate to tenant’s right to the security deposit. A landlord’s creditors have no recourse against security deposits held by the

landlord for its tenants. Creditor's claims to any balance remaining after lawful deductions are subordinate to the tenant's rights to a refund of the balance. [Cal. Civ. Code § 1950.5(d)]

- Accounting and refund requirements: Two week deadline. No later than 21 days after a tenant's vacancy, the landlord must: provide the tenant, by personal delivery or postage prepaid first class mail, with a copy of an *itemized statement* indicating the basis for and amount of any security received and the disposition of that security; and return to the tenant "any remaining portion of the security." [Cal. Civ. Code § 1950.5(g)(1)]

iv. Remedies for unlawful retention of security. Landlords and their successors risk damages liability for violating the statutory restrictions on dealing with residential tenant security deposits.

- Damages suit for "bad faith". The tenant can bring a civil action based on *either*: (1) the landlord's or successor's "bad faith" claim or retention of security (or portion thereof) in violation of Section 1950.5 (i.e., upon termination of the tenancy); or (2) the successor's "bad faith" demand for replacement of security in violation of Section 1950.5(i). [Cal. Civ. Code § 1950.5(k)]
- Statutory damages. The plaintiff tenant is entitled to recover a statutory penalty of up to \$200, *plus* actual damages and *interest* on the security, or the remaining portion thereof, at the rate of 2% *per month* from the due date until paid for "bad faith" conduct.

b. Security deposits for a rental agreement for commercial property are governed by California *Civil Code* Section 1950.7.

- i. No restrictions on amount of deposit. Unlike *Civil Code* Section 1950.5, governing residential tenancies, there are no restrictions on the amount of security that commercial landlords may demand or collect.
- ii. Limitations on retention of security at termination of tenancy. Unlike residential landlords, commercial landlords are not

expressly precluded from providing for *nonrefundable* security deposits. Even so, commercial landlords may claim “only those amounts as are *reasonably necessary* to:

- Remedy tenant defaults in the payment of rent;
- Repair damage to the premises caused by the tenant; or
- Clean the premises upon termination of the tenancy . . . provided the deposit was made for “any or all” of these specified purposes. [Cal. Civ. Code § 1950.7(c)]

iii. Creditor claims subordinate; bankruptcy exception. Commercial tenants, like residential tenants, have a *priority* right to receive refundable portions of the security as against claims of the landlord’s creditors. However, there is *one distinction*: in the commercial context, a trustee in bankruptcy has a superior right over the tenants to reach security held by a debtor landlord. [Cal. Civ. Code § 1950.7(b)]

iv. Refund requirements.

- Retaining deposit to remedy rent default. When a landlord’s claim to a commercial tenant’s security deposit is *only* for defaults in the payment of rent, any balance of the deposit exceeding the amount in default must be returned to the tenant *no later than two weeks* after the date the landlord receives possession of the premises. [Cal. Civ. Code § 1950.7(c)]
- Deposit may not be applied to offset future judgment. It is *error* to apply the deposit against any eventual *judgment* the landlord obtains against the tenant or any claim that might accrue to the landlord in the future. [Public Employees’ Retirement System v. Winston (1989) 209 Cal.App.3d 205, 209-210, 258 Cal. Rptr. 612, 614] The ramifications of doing so may have drastic consequences in connection with “prevailing party” rights to costs and contract attorney fees. For example, the trial court’s error in applying the deposit against the money judgment in landlord’s action for unpaid rent and attorney fees in the *Winston* case, resulted in the *improper* determination that the

landlord was the “prevailing party” when, by applying the correct offset rule, the prevailing party was the tenant.

- Retaining deposit for repairs or cleaning. Where v the landlord’s claim to the security includes amounts reasonably necessary to repair damage or clean the premises, any balance (not reasonably needed for cleaning or repairs) must be returned to the tenant at a time they mutually agree upon . . . but in no event later than *30 days* from the date the landlord receives possession of the premises. [Cal. Civ. Code § 1950.7(c)]

2. Costs Of Collection.

There are costs involved in attempting to effectuate collection from a tenant. It is important to consider what is owed and the costs of collection before attempting to effectuate collection. The lease may contain a provision that states that the tenant is required to pay the costs incurred in the collection process, but if the costs are not collectable, the landlord will be throwing good money after bad money.

i. Filing Fees.

If you are a natural person and want to file a lawsuit for \$10,000 or less, you may commence the action by filing a small claims case. If you are a business, you can file in small claims court for \$5,000 or less. The cost depends upon the amount of the claim. The filing fees range from \$30.00 to \$75.00 depending upon the amount of the claim. You also have to pay a fee to have the complaint served. [CCP § 116.220(a)(1); CCP § 116.221]

If the claim is more than \$10,000.00 and up to \$25,000.00, you are required to file a “limited civil case.” The filing fee for a limited complaint in an unlawful detainer case is \$385.00. [GC § 70613(a); CCP § 1161.2]

If the claim is more than \$25,000.00, you are required to file an “unlimited civil case.” The filing fee for an unlimited complaint in unlawful detainer is \$435.00. [GC § 70611]

ii. Attorney's Fees.

Attorney's fees vary depending upon the time, experience and volume of work the attorney does in the matter. Attorney's fees range from approximately \$125.00 to \$500.00 per hour, and will vary depending upon the experience of the attorney. Given the amount of time that may have to be dedicated to a particular matter, the attorney's fees can easily exceed several thousand dollars; therefore, collectability is a critical issue.

Because collectability is such a critical issue, you will need information to determine the collectability of the debt that may be owed. The information needed will in many cases come from what you obtained at the beginning when the tenant applied to rent your property.

OBTAINING NECESSARY CONTACT INFORMATION EARLY IN RENTAL PROCESS TO FACILITATE EASIER RECOVERY OF FUNDS

The more information the landlord has regarding a tenant's contact information, employment history, and assets, the easier it will be to attempt to collect on a judgment. When filling out a rental application, or obtaining information for the lease agreement, it is highly recommended that the landlord obtain the tenant's full name, any alternative names the tenant may use, driver's license, vehicle information, employer's information, and whether the tenant has any bank accounts. It is likewise recommended that the landlord obtain emergency contact information for the tenant in the event there is an issue at the leased premises and the landlord is unable to make contact with the tenant. Having the contact information of a family member or friend may also assist the landlord in later locating the tenant when attempting to collect on a judgment.

1. Rental Application.

One of the easiest ways to get information about a potential tenant is to have the prospect complete a rental application. This information may be very helpful in effectuating collection from the tenant in the future.

i. Information From Rental Application.

The rental application should request information about all the individuals who will occupy the premises. If you have information about other occupants, you may be able to contact them in an effort to locate the tenant to seek collection. If the rental application requests a list of emergency contact names and personal references, it may assist you in locating the tenant after the premises has been vacated.

The rental application should request information about the tenant's employment. This information may assist you in serving the former tenant with the summons and complaint if you decide to bring a lawsuit and enable you to garnish wages in the event you are able to obtain a judgment.

The rental application should request information about the vehicles that may be parked at the property. This information may enable you to locate the former tenant through Department of Motor Vehicles records.

The rental application should request both the prospective tenant's social security number and birth date. This information may also assist you in locating the former tenant.

2. Credit Report.

It is common to request a credit report from a prospective tenant. The information contained in the credit report may assist you with your collection efforts. If you are able to obtain a credit report after the tenant leaves, it may give you information about the tenant is doing financially. Does the former tenant timely make the credit card payments? Does the former tenant have a lot of outstanding loans? The answers to these questions may assist you in deciding whether or not to proceed with collection efforts.

3. Payment Information.

It is a prudent practice to keep a copy of the rent checks. This will potentially enable you to locate funds on deposit that may be levied upon to satisfy a future judgment.

Once the initial period has passed and assuming the relationship has not yet soured (i.e., the landlord and tenant are still working together), the landlord should continue to obtain as much information as possible through continued contact with the tenant, regularly seeking updated financial and contact information.

Once the relationship with the tenant has soured, and assuming the amount being pursued is large enough to be economically feasible, a private investigator can be hired to obtain information that might assist in collection efforts. Using the internet, free searches can be run at the Secretary of State's office to learn about business names, UCC filings and partnerships. Most county's real estate and tax records are also online for real property searches. The department of motor vehicles can be searched for car registrations. Online telephone book directories can be searched for contact information. Most courts' dockets (state, federal, bankruptcy and domestic relations) are now online to see if there are any other pending or prior cases that may reveal asset information. Last known employers, landlords and neighbors can also be contacted (subject to the Fair Debt Collection Practices Act). If all else fails, you can also "Google" someone.

Most of the above listed searches are free. Asset information can also be obtained through pay sites such as LexisNexis' Comprehensive SmartLinx ® Search Program; Dun and Bradstreet (for business reports); LexisNexis® Accurint and OPENOnline nationwide employment background checks.

4. Factors When Considering Settlement

The reasonableness of any settlement is a case by case determination. Reaching a reasonable settlement involves taking a global approach and truly assessing your case.

- i. Pre Lawsuit Settlement Discussions. If settlement is being discussed prior to a lawsuit filing for unpaid rent/damages, factors to consider are the size and strength of the case. For example, will a witness be willing to appear and testify? Do you have all of the supporting documentation to prove your claim? Does the defendant have a viable defense or counterclaim to your claims?
- ii. Post Lawsuit Settlement Discussions. If settlement is being discussed post-judgment, is the debtor collectible? Are the debtor's assets easily convertible to money (for, e.g., wage garnishment vs. automobile repossession)? Does the debtor have any exemptions they can assert? Does the debtor have any higher priority garnishments (for e.g., child support)? All of these factors will need to be carefully considered in order for you to make the best decision regarding settlement offers.
- iii. Installment And Lump Sum Payments.¹ It is not uncommon to be contacted by the debtor with an offer for a monthly payment arrangement or a lump sum settlement. Assuming that an eviction action has already been filed, this contact may occur at the following times: 1) prior to the obtaining of the judgment for possession; 2) prior to the obtaining of the judgment for damages; 3) after the judgment for damages has been secured but before post-judgment collection efforts have begun; or 4) after the judgment has been secured and after you have started to attach the debtor's bank account, wages or other personal property.
 - Whenever the contact from the debtor occurs, do not miss the opportunity to re-verify and/or obtain asset and location information from the debtor that can be used in consideration of whether or not to accept the payment plan and for further collection efforts.
 - Consider the past payment history (if any) with the debtor. Past broken payment arrangements are a red flag that they will not actually follow through on their promises.

¹ This section is applicable to situations where the debtor contacts you wanting to arrange payments and/or stop a lawsuit or garnishment on a cause of action for damages.

- Require that the lump sum payment or any payments be made in cash or certified funds (bank check or money order). Disclose to the debtor that any personal checks that are returned will be subject to a charge.
- If collection efforts have started and there are attached funds in question that are not exempt, do not offer to release monies that have already been garnished. Whether or not they are in transit to the court, in the court waiting for disbursement or in your office; debtors generally believe that once the money is out of their possession, it has been applied against the debt and they are contacting you regarding the remaining balance.
- If dealing with a situation where you are contacted after a wage garnishment has been filed, consider modifying/reducing the withholding amount as opposed to releasing the garnishment and trusting that the debtor will voluntarily pay.
- Generally speaking, most clients will discount the amount due when a lump sum payment is being offered vs. a monthly payment arrangement.

RECOVERABLE DAMAGES, TAKING AND DOCKETING JUDGMENT, GARNISHMENT OF PROPERTY OR EARNINGS

1. Recoverable Damages
 - a. Landlord's Liability

If a tenant believes that his rental unit needs repairs, and the landlord is responsible for the repairs under the implied warranty of habitability, and if the landlord does not make the requested repairs and doesn't have a good reason for not doing so, the tenant may have one of several remedies, depending on the seriousness of the repairs.¹ One option is for the tenant to file a lawsuit against the landlord to recover money damages. This kind of lawsuit can be filed in small claims court or Superior Court, depending on the amount demanded in the suit. The tenant can file this kind of lawsuit without first trying another remedy, such as the repair and deduct remedy.

If the tenant wins the lawsuit, the court may award the tenant his or her actual damages, plus "special damages"² in an amount ranging from \$100 to \$5,000. [Cal Civ. Code §1942.4(b)(1)]

The court also may order the landlord to abate (stop or eliminate) a nuisance and to repair any substandard condition that significantly affects the health and safety of the tenant. [Cal Civ. Code § 1942.4(a), (c)] For example, a court could order the landlord to repair a leaky roof, and could retain jurisdiction over the case until the roof is fixed.

In order for a tenant to win such a lawsuit against the landlord, all of the *following*

¹ The remedies of repair and deduct; abandonment; and rent withholding allow a tenant in a rental unit with serious habitability defects to take action against the landlord without filing a lawsuit. Arbitration and mediation are other methods of resolving disputes about the condition of a rental unit. In order to invoke the repair and deduct or the abandonment remedy, the defects must be serious and directly related to the tenant's health and safety. In order for a tenant to invoke the rent withholding remedy, the defects or repairs needed must be *more* serious than would justify use of the repair and deduct and abandonment remedies. For example, collapse and nonrepair of the bathroom ceiling, continued presence of rats, mice, and cockroaches, lack of any heat in four of the apartment's rooms, plumbing blockages, exposed and faulty wiring, and an illegally installed and dangerous stove were determined by the court to be serious enough to justify withholding of rent in *Green v. Superior Court* (1974)10 Cal.3d 616, 111 Cal.Rptr. 704; *see, also, Hyatt v. Tedesco* (2002) 96 Cal.App.4th Supp. 62, 117 Cal.Rptr.2d 921, for additional examples of substantial defects that violated the implied warranty of habitability.

² "Special damages" are costs that the tenant incurs, such as the cost of a motel room, because the landlord did not repair defects in the rental unit. The party who wins the lawsuit is entitled to recover his or her costs of bringing the suit (for example, court costs), plus reasonable attorney's fees as awarded by the court. [Cal. Civ. Code §1942.4(b)(2); Cal. Code Civ. Proc. § 1174.2]

conditions must be met. [Cal Civ. Code § 1942.4(a); see, Cal Health & Safety Code §§ 17920.3, 17920.10]

- The rental unit has a serious habitability defect. That is, the rental unit contains a lead hazard that endangers the occupants or the public; or substantially lacks any of the a nuisance endangers the health, life, safety, property, or welfare of the occupants or the public; and
- A housing inspector has inspected the minimum requirements for habitability and has notified the landlord in writing of his or her obligations to abate the nuisance or repair the substandard conditions; or the premises has been declared substandard because, for example, a structural hazard, inadequate sanitation, or premises and has given the landlord or the landlord's agent written notice of the landlord's obligation to repair the substandard conditions or abate the nuisance; and
- The nuisance or substandard conditions continue to exist 35 days after the housing inspector mailed the notice to the landlord or agent, and the landlord does not have good cause for failing to make the repairs; and
- The nuisance or substandard conditions were not caused by the tenant or the tenant's family, guests, or pets; and
- The landlord collects or demands rent, issues a notice of rent increase, or issues a three-day notice to pay rent or quit after all of the above conditions have been met.

California *Civil Code* Section 1942.4, which authorizes a tenant's suit against the landlord, also can be used defensively. If the landlord commences an unlawful detainer action against the tenant based on nonpayment of rent, and the court finds that the landlord has violated all of the five conditions of Section 1942.4, the landlord is liable for the tenant's attorneys' fees and costs of suit, as determined by the court. [Cal. Code *Civ. Proc.* § 1174.21]

b. Tenant's Liability

Under California law, a pair of statutes set forth the primary rules governing the respective rights and obligations of a landlord and a tenant when a lease is terminated non-consensually. Those statutes are Civil Code sections 1951.2 and 1951.4.

Section 1951.4 permits the landlord to hold the tenant to the lease (even if the tenant has abandoned the premises). The landlord can then sue for the rent as it comes due and otherwise "enforce all the lessor's rights and remedies under the lease." [Cal. Civ. Code § 1951.4(b)] In order for a landlord to be entitled to the remedy provided by Section 1951.4, the lease must expressly state that the landlord has the rights set forth in that statute and the tenant must have the right to sublet or assign the premises under the terms of its existing lease with the landlord. This effectively shifts the burden to the tenant to find another tenant to occupy the premises.

The more common remedy sought by landlords is to retake possession of the property and then sue for past due rent and lost future rent. Section 1951.2 spells out the law governing this measure of damages. The effect of the statute is to allow the landlord to recover certain damages from the tenant after the landlord has terminated the tenant's "right to possession" and retaken possession. This is usually done after an eviction or an abandonment by the tenant. In addition to past due rent, the tenant is liable for the landlord's lost future rent, i.e. the rent owed for the balance of the entire lease term.

There are two important limitations on an award to the landlord of damages for lost future rent. First, the award of lost future rent must be reduced by the amount of the "rental loss that the lessee proves could be reasonably avoided." [Cal. Civ. Code § 1951.2(a)(3)] In most cases, some, if not all, future rent loss can be mitigated by the likely rent from a replacement tenant. Second, the award must be computed by "discounting" the future lost rent by a certain rate of interest. [Cal Civ. Code § 1951.2(b)] Essentially, this means reducing the future rent revenue stream to its present value in order to compensate for the fact that the future rent would not have been earned at the time the damages are awarded to the landlord.

In addition to lost rent damages, a landlord may be entitled to recover "consequential" damages. These are losses which the landlord sustains as a direct result of the tenant's breach of the lease. However, a landlord cannot recover more in total rent and consequential damages than the landlord would have realized had the tenant not breached the lease.

2. Special Enforcement Procedures

a. Examination of judgment debtor and third parties.

An examination of a judgment debtor or third party is the post judgment equivalent of a deposition. An examination can be used to identify property in the possession or control of the judgment debtor or a third person (e.g., a nondebtor spouse), to learn about property the debtor may obtain in the future, and to require the debtor or third person to turn over the property to the levying officer.

i. Statutory Authority.

- Examination of judgment debtor. Upon service of an examination order, the judgment debtor must appear in court “to furnish information to aid in enforcement of the money judgment.” [CCP § 708.110(a)]
- Examination of third parties. A third person may be ordered to appear for examination upon the judgment creditor’s application showing to the court’s satisfaction that the third person is in possession or control of property in which the judgment debtor has an interest or is indebted to the debtor for more than \$250.00. [CCP § 708.120] It is generally advisable to serve a third party with a writ of execution (garnishment) before proceeding with an examination. Even if the levy is ineffective, the third person must complete a garnishee’s memorandum. This may provide the same information that could be obtained from an exam, and will be much cheaper. But if the third person’s response to the garnishment is unsatisfactory, an exam may be in order.

ii. Advantages.

- Lien created. Service of an examination order on *the judgment debtor* generally creates a one-year lien on *all* of the debtor’s nonexempt personal property whether or not it is in the debtor’s possession and control. [CCP § 708.110(d)] Whereas an examination order served on a third person creates a one-year lien on the debtor’s interest in property in the third person’s possession or control, provided the

property is adequately described in the creditor's application for the examination order. [CCP § 708.120(c)]

- Turnover orders obtainable. At the conclusion of the exam, the creditor may obtain a "turnover order" requiring the debtor or third person to deliver the identified assets to the levying officer or, in some cases, the creditor or a receiver. Such orders are enforceable by contempt, and may be far more effective than levying on property under writ of execution.
- Effective discovery of assets. An in person examination under oath may be a more effective means to discover assets than propounding interrogatories or employing an asset search firm.
- Encourages settlement. Examining the debtor or third party also gets the debtor's attention and shows him or her that the creditor is serious about collecting the judgment. This may motivate good faith settlement efforts by the debtor. It is not unusual for the debtor to contact creditor's counsel immediately after the examination order is served to offer a settlement. However, unless the debtor is believed to be truthful or the judgment is small, it may be advisable not to negotiate until after the examination is conducted and all the facts are known.

iii. Disadvantages.

- Expensive. Examinations can be expensive. The judgment creditor might be able to obtain the same information more cheaply by employing a private asset search firm or conducting its own informal investigation.
- Debtor "tipped off". As soon as the examination order is served, the debtor knows that the creditor is actively seeking collection. As a result, the debtor might attempt to dissipate, transfer or conceal assets, or may file bankruptcy. The debtor's personal property will generally be subject to the one-year lien,

but the lien might be lost by the debtor's sale to a bona fide purchaser.

- b. Written interrogatories to judgment debtor. A judgment creditor is entitled to serve written interrogatories on a judgment debtor to obtain information to aid in enforcement of a money judgment. [CCP §§ 708.010(a); 708.020(a)]
 - i. Advantages. Interrogatories are cheaper than a judgment debtor examination and usually require less preparation time. If adequately responded to, they can provide current answers about the debtor's employment status, income, assets and liabilities. Interrogatories can also be used to "set up" a later examination, or to follow up on questions not completely answered at an examination.
 - ii. Disadvantages. Judgment debtors frequently do not answer them, and a sanctions award for failure to answer is often uncollectible. Interrogatories are also slow (the judgment debtor has at least 30 days to answer), and not spontaneous. Moreover, service of interrogatories does not create a lien on the debtor's property. Also, interrogatories cannot be sent to third persons (e.g., a nondebtor spouse).
- c. Inspection demand to judgment debtor. A judgment creditor may serve an inspection demand on a judgment debtor to obtain information to aid in enforcement of a money judgment. [CCP § 708.030(a)]
 - i. Advantages. An inspection demand may provide the judgment creditor with documents disclosing the debtor's assets or earnings (e.g., tax returns, financial statements, payroll stubs, real property deeds, stock certificates, passbooks, deposit account statements, bonds, trust deeds, automobile ownership certificates, promissory notes, etc.) An inspection demand is cheaper than a judgment debtor examination. An inspection demand can also be used to "set up" a later examination of the judgment debtor.
 - ii. Disadvantages. Judgment debtors frequently do not respond, and a sanctions award for failure to respond is often uncollectible. Inspection demands are also slow (the inspection generally will not occur for at least 30 days after service of the demand), and not spontaneous. Moreover, service of an inspection demand does not create a

lien on the debtor's property. Also, an inspection demand cannot be sent to third persons (e.g., a nondebtor spouse).

- d. Creditor's suit. If a third person possesses or controls property in which the judgment debtor has an interest (or is indebted to the judgment debtor), the judgment creditor may bring suit against the person to apply the property or debt to the money judgment. [CCP § 708.210]
- i. Creditors should generally use less expensive and cumbersome procedures, such as a garnishment levy, obtaining an assignment order, or examining the third person.
- ii. A creditors' suit should be considered only where:
- The judgment debtor will not sue the third person to recover moneys or property due because, e.g., the debtor does not expect to recover anything for himself;
 - The third person must be quickly enjoined from transferring money or property due the judgment debtor to another party or parties;
 - The third person fails to perform the duties of a garnishee [CCP § 708.010] (i.e., absent "good cause" for refusal, a third person garnishee ordinarily must:
 - 1) deliver to the levying officer property of the judgment debtor levied upon that was in the possession or control of the third person at the time of levy;
 - 2) execute and deliver to the levying officer any documents necessary to transfer title to such property;
 - 3) and where the levy is upon an "obligation" owing to the judgment debtor, pay to the levying officer amounts currently due at the time of the levy and amount coming due and payable thereafter while the execution lien remains in effect (two year from issuance of the writ).
 - The court, in situations where a third person makes a third party claim to an interest adverse to the judgment debtor as to property in its possession or control, refuses to determine disputed ownership of

property or existence of a debt under CCP § 708.180(b)(3).

- The third person is so uncooperative that a separate lawsuit is required.
- e. Assignment order. If a judgment debtor has a right to any future payment, a court may order an assignment of all or part of such right to a judgment creditor.
- i. Assignable payment rights.
- Wages due from the federal government;
 - Rents;
 - Commissions and royalties;
 - Payments due from a patent or copyright;
 - Nonexempt insurance policy loan value of an unmatured life insurance, endowment or annuity policy;
 - Accounts receivable; and
 - Judgments.
- f. Receiver to enforce judgment. The court may appoint a receiver to enforce a judgment upon a showing by the judgment creditor that the appointment is a “reasonable method to obtain the fair and orderly satisfaction of the judgment. [CCP § 708.620]
- i. Examples when a receiver may be appointed:
- Where a writ of execution does not reach certain property and other remedies are inadequate (e.g., receiver may be appointed to sell patents, trademarks or copyrights);
 - In examination proceedings (e.g., appointment of receiver and order that judgment debtor make any necessary assignments or deliveries to the receiver for the purpose of sale or collection);
 - To enforce a charging order against a partnership or limited liability company;

- To preserve the value of perishable property; and
 - To enforce a judgment for the possession or sale of property.
- g. Charging orders against debtor partnership/LLC interests. Assets in a partnership (general or limited) or limited liability company are not liable upon a money judgment rendered against a partner or member personally (i.e., partnership or LLC assets are not subject to execution unless the judgment is against the partnership or LLC itself. To reach a debtor's partnership or LLC interest, the judgment creditor ordinarily must obtain a court order charging those interests with the amount of the judgment. [CCP §§ 699.720(a)(2) 708.310]
- i. Lien created by service of motion. A lien on a judgment debtor's interest in a partnership or LLC is created by service of a notice of motion for a charging order on the judgment debtor and either (1) all partners or the partnership; or (2) all members of the LLC. [CCP § 708.320(a)]
- The lien continues under the terms of the court's charging order until the judgment becomes unenforceable. However, if the court refuses to issue a charging order (or if the judgment is stayed pending appeal), the lien is extinguished. [CCP §§ 697.030, 697.040, 708.320(b)]

3. Judgment Liens

a. Real Property

- i. All real property interests affected. A judgment lien on real property is a general lien, attaching to practically all of the judgment debtor's real property interests in the county were an abstract or certified copy of the judgment is recorded. The lien is created even though the particular real property interests are not described and regardless of whether the judgment creditor knows they exist.
- ii. Lien attaches to after-acquired property. The lien attaches to both real property interests presently held by the judgment debtor and those acquired in the future, thus assuring the judgment creditor priority as to after-acquired interests. [CCP §§ 697.340(b)]

- iii. Fast and inexpensive. A judgment lien on real property is one of the quickest, simplest and least expensive enforcement procedures available. The lien is created simply by recording an abstract of the judgment (or, in appropriate cases, a certified copy of the judgment). The judgment debtor generally has to pay off the lien in order to sell or refinance the property.
- iv. Lien more likely to become “seasoned”. A judgment lien is less disruptive to the judgment debtor and therefore less likely to trigger the debtor’s filing a bankruptcy petition than a levy under writ of execution. Creation of a judgment lien does not disturb the judgment debtor’s right to use and possess real property, and is not as alarming to the judgment debtor as notice of levy and sale under execution. Thus, there is a better chance that the debtor will not file bankruptcy promptly after the abstract is recorded. As a result, the lien may become “seasoned” by expiration of the 90-day period for setting aside preferential transfers under 11 U.S.C. section 547.
- v. “Freeze” on debtor’s homestead exemption. If an attachment lien was not recorded, creation of a judgment lien “freezes” the judgment debtor’s homestead exemption amount. Any subsequent increases in the exemption authorized by statute do not apply to the judgment lien creditor. [CCP §§ 703.050, 703.100]

b. Personal Property

- i. Quicker than execution. Unlike a real property lien or writ of execution which must be issued by the court clerk, a judgment lien on personal property (“JLPP”) is prepared by the creditor’s attorney and then filed with the Secretary of State.
- ii. May avoid necessity of execution. The JLPP gives the judgment creditor priority over unsecured creditors without the necessity of levying execution. This is a clear advantage where there are outstanding security interests in the property, because the judgment creditor may not want to execute in such cases (the secured creditors would have priority and could file third party claims which might defeat the execution levy).
- iii. Lien continues after transfers to most BFPs. Other procedures available for liening business personal property (e.g., through

an examination proceeding, or creditors' suit, do not protect against transfers to certain types of persons. [CCP §§ 697.740, 697.910, 697.920] The JLPP lien continues after the property is transferred, unless inventory is transferred to a buyer or lessee in the ordinary course of business.

- iv. Better chance of "seasoning". As with a judgment lien on real property, a JLPP is not disruptive to the debtor's possession or use of the property, whereas a levy and sale under execution normally requires that the property be seized or garnished. Therefore, a JLPP is less likely to motivate the debtor to file bankruptcy before the expiration of the 90-day voidable preference period.
- v. Inexpensive. A JLPP is also one of the least expensive enforcement methods. It can be prepared by the judgment creditor's attorney and filed with the Secretary of State.
- vi. Types of Property Subject to JLPP. A JLPP reaches only the following types of personal property in which a security interest could be perfected by filing a financing statement with the Secretary of State under the Commercial Code.

4. Execution Levies and Wage Garnishments

- a. Enforcement of judgments by writ of execution. A writ of execution is a court process directed to the levying officer (i.e., sheriff, marshal or constable) of the county where the levy is to be made and to any registered process server. The writ requires the levying officer to enforce the money judgment in the manner prescribed by law. [CCP § 699.520]
 - i. Advantages.
 - Most property interests subject to execution. Execution may be used to reach virtually all of a judgment debtor's property interests. This includes a judgment debtor's interest in real property and in most tangible and intangible personal property. An execution lien may also reach a debtor's property interests in the possession or control of a third person, or a debt owed the judgment debtor by a third person.
 - Levy liens the property. The levying officer executes the writ by taking the property into custody (actually or constructively). The execution levy creates a lien on the real

or personal property levied upon. And, for priority purposes, the lien “relates back” to the date a prior effective judgment or attachment lien was created. [CCP § 697.020]

- Property sold or collected. Following the levy, the debtor’s interest in the property may be sold at an execution sale and the proceeds applied to satisfy the judgment. Other property (e.g., checks, accounts receivable, notes and other instruments) may be collected by the levying officer, rather than sold.

- May encourage settlement. Even if the judgment is not satisfied by execution sale, levying a writ will usually get the debtor’s attention and demonstrate that the creditor is serious about collecting the judgment. This may encourage the debtor to negotiate a good faith settlement of the judgment.

ii. Disadvantages.

- Creditor must identify debtor’s assets. In contrast to the creation of judgment liens, a writ of execution creates a lien only by levying upon specified known property of the debtor. The creditor must provide the levying officer with instructions identifying the property and its location, as well as the names and addresses of all persons who must be served.

- Generous exemptions for individual debtors. State and/or federal laws provide generous exemptions protecting the property of individual judgment debtors from execution. For example, a judgment debtor’s dwelling may be exempt for up to \$175,000.00.²

² California exemptions are generally set forth at *Code of Civil Procedure* Section 704.010 *et seq.* These exemptions were last updated by the California Judicial Council to adjust for inflation on April 1, 2013. The next update will be April 1, 2016.

Homestead

The homestead exemption protects a certain amount of equity in your principal residence. A debtor can exempt real or personal property he reside in at the time of judgment enforcement or filing for bankruptcy, including a mobile home, boat, stock cooperative, community apartment, planned development or condominium, up to: \$75,000 if single and not disabled; \$100,000 if family and at least one family member has no interest in the homestead; \$175,000 if 65 or older or if physically or mentally disabled; \$175,000 if creditors are seeking to force the sale of your home and you are either (a) 55 or older, single and earn under \$25,000 per year, or (b) 55 or older, married and earn under \$35,000 per year. [CCP § 704.730]

Motor Vehicle

The motor vehicle exemption is designed to protect a certain amount of equity in a debtor's car, truck, motorcycle, or other vehicle. The motor vehicle exemption is \$2,900. [CCP § 704.010]

Personal Property

- Household items and personal effects. [CCP § 704.020]
- Residential building materials to repair or improve home up to \$3,050. [CCP § 704.030]
- Jewelry, heirlooms and works of art up to \$7,625. [CCP § 704.040]
- Health aids. [CCP § 704.050]
- Bank deposits arising out of Social Security payments up to \$3,050 for a single payee (\$4,575 for husband and wife payees) and unlimited if funds are not commingled; bank deposits from other public benefit payments up to \$1,525 (\$2,275 for husband and wife as joint payees) . [CCP § 704.080]
- Personal injury and wrongful death causes of action and recoveries that are necessary for support. [CCP §§ 704.140 and 704.150]
- Cemetery and burial plot. [CCP § 704.200]

Wages

- 75% of wages paid within 30 days prior to filing bankruptcy. [CCP § 704.070]
- Public employee vacation credits (at least 75% if receiving installment payments). [CCP § 704.113]

Retirement & Pensions

- Public retirement benefits. [CCP § 704.110]
- Private retirement plans and benefits, including IRA and Keogh. [CCP § 704.115]
- Public employees. [Cal. Gov't Code § 21255]
- County employees. [Cal. Gov't Code § 31452]
- County peace officers. [Cal. Gov't Code § 31913]
- County fire fighters. [Cal. Gov't Code § 32210]

Public Benefits

- Unemployment and disability benefits, and union benefits due to labor disputes. [CCP § 704.120]
- Workers' compensation benefits. [CCP § 704.160]
- Public assistance benefits. [CCP § 704.170]
- Relocation benefits. [CCP § 704.180]
- Student financial aid. [CCP § 704.190]

- Expensive. If tangible personal property is seized, it must be moved to storage and held for sale. Levying officers may require substantial deposits to cover these costs and, although enforcement costs can be added to the judgment, they may be difficult to collect.
- Possibly disappointing net realization from execution sale. Although execution sales are advertised, they rarely result in market value realizations. A creditor who bids the amount of the judgment may end up owing the debtor's interest in the asset. This may not be desirable.
- May encourage bankruptcy. Perhaps the most serious drawback to execution is that it is a highly intrusive procedure that may prompt the debtor to file for bankruptcy (e.g., where the inventory of a going business is seized or a debtor's dwelling is levied upon.)

iii. Venue restrictions; consumer debts. As is the situation with wage garnishments, the Federal Fair Debt Collection Practices

Tools of Trade

- Tools, implements, materials, books, uniforms, instruments, one commercial vehicle, equipment, and furnishings up to \$7,625 total, or up to \$15,250 if used by both spouses in the same occupation. Commercial vehicle up to \$4,850, or \$9,700 if used by both spouses in the same occupation. [CCP § 704.060]

Insurance

- Matured life insurance benefits needed for support of unlimited value, or unexpired life insurance policy up to \$12,200. [CCP § 704.100]
- Disability or health insurance benefits. [CCP § 704.130]
- Homeowners' insurance proceeds for six months after received, up to amount of homestead exemption. [CCP § 704.720]
- Fidelity bonds. [Cal. Labor Code § 404]
- Life insurance proceeds if policy prohibits use to pay creditors. [Cal. Insurance Code §§ 10132, 10170, 10171.]

Miscellaneous

- Business or professional licenses. [CCP § 695.060]
 - Trust funds of inmates up to \$1,525. [CCP § 704.090]
 - Property of business partnership. [Cal. Corporations Code § 16501]
-

Act imposes strict venue restrictions on the collection and enforcement of consumer debts (i.e., it prohibits debt collectors from bringing any “legal action on a debt” against a consumer outside the judicial district where the consumer resides, possess real property or signed the contract sued upon [*see*, 15 U.S.C. § 1692i] Obtaining a garnishment writ in violation of these provisions may subject a creditor and his attorney to liability.

- b. Deposit accounts and safe deposit boxes. Bank deposits or property in safe deposit boxes can be reached only if the levying officer (or registered process server) personally serves a copy of the writ and notice of levy on (1) the branch where the deposit account or safe deposit box is maintained; or (2) in the case of deposit accounts, at a centralized location within the county designated by the financial institution. [CCP §§ 700.140(a), 700.150(a)]
 - i. At the time of levy or promptly thereafter, the levying officer must also serve the judgment debtor with copies of the writ, notice of levy and, if the judgment debtor is a natural person, statement of exemptions and their dollar amounts. [CCP § 700.010]
 - ii. Effect of levy on deposit accounts or safe deposit boxes. An execution levy on a deposit account reaches all funds in the account at the instant of levy. It also reaches uncollected funds (i.e., checks or items that have been deposited but not yet credited because they are in the process of being collected (unless such items are returned unpaid). [CCP § 700.140(a)]
 - Checks not honored. While the execution lien is in effect, the financial institution may not honor a check or other order for payment drawn against the liened account if to do so would reduce the account balance to less than the amount levied upon. (Funds in the process of collection are not counted in determining the amount of the account.) [CCP § 700.140(c)]
- ii. Removal of safe deposit box contents. The financial institution may not permit removal of any of the contents of a safe deposit box while the lien is in effect, except as directed by the levying officer. [CCP § 700.150(c)]

- c. Wage garnishment. By using the procedures of the Wage Garnishment Law (“WGL”), a judgment creditor may compel an individual judgment debtor’s employer to withhold the nonexempt portion of the debtor’s disposable earnings for payment directly to the levying officer, to be applied to satisfy the judgment.
- i. Advantages. Wage garnishment may be the only means available to enforce a judgment where other property of the debtor is exempt. So long as the judgment creditor knows the name and address of the judgment debtor’s employer, it is relatively easy and inexpensive to garnish a debtor’s wages.
- In contrast, a court order is required to garnish the wages of a nondebtor spouse because, despite the general rule that community property is liable for the debts of a spouse, community property earnings are unique and may not be liable in some situations. [See, CCP §706.109]
- ii. Service of an effective earnings withholding order creates a lien on the employee’s earnings and generally on all property of the employer subject to enforcement of a money judgment, in the amount required to be withheld. [CCP §706.029] However, the lien is limited to the amount required to be withheld (which may not be very much).
- iii. A wage garnishment may prompt the debtor to pay off the judgment or agree to a voluntary payment plan since a wage garnishment is embarrassing to the debtor, and employers generally do not appreciate the extra bookkeeping burden created by earnings withholding orders.)
- d. Disadvantages. The main drawback is that at least 75% of a debtor’s earnings are automatically exempt from garnishment, except as to judgments for support. Thus, unless the debtor earns a large salary, the creditor will receive relatively little from a wage garnishment.

For example, if a judgment debtor is earning \$10 per hour and works 40 hours a week, his weekly disposable earnings total \$400. After deductions, a debtor’s weekly income is approximately \$380. Under federal law, a judgment creditor can garnish the lesser of \$95 (25% of \$380) or \$162.50 ($\$380 - (30 \times \$72.50)$, federal minimum wage). Under California law, a judgment creditor can garnish the lesser of \$95 (25% of \$380) or \$20 ($\$380 - (40 \times \$9.00)$, California minimum

wage). Thus, very little of a debtor's earnings can be used to satisfy a judgment.

- i. A wage garnishment may prompt the debtor to file a bankruptcy petition. If the debtor receives a discharge in bankruptcy, the wage garnishment will not attach to the debtor's postpetition wages. [*In re Baker*, 217 B.R. 609, 610-613 (Bankr. N.D. Cal.1979)]

- d. Venue restrictions; consumer debts. As is the situation with execution levies, the Federal Fair Debt Collection Practices Act imposes strict venue restrictions on the collection and enforcement of consumer debts (i.e., it prohibits debt collectors from bringing any "legal action on a debt" against a consumer outside the judicial district where the consumer resides, possess real property or signed the contract sued upon [*see*, 15 U.S.C. § 1692i] Obtaining a garnishment writ in violation of these provisions may subject a creditor and his attorney to liability.

BANKRUPTCY AND OTHER ISSUES

Regardless of whether a Chapter 7, 11 or 13 bankruptcy is filed, the moment a bankruptcy petition is filed, an automatic stay is triggered barring most actions to recover a debt or affect property of the debtor. This includes any act to obtain possession of property of the bankruptcy estate such as rental property unless an exception applies. A bankruptcy filing may also result in the landlord being sued to set aside payments received within 90 days of the bankruptcy filing in furtherance of collection activities. A basic understanding of the bankruptcy system is therefore critical to judgment enforcement.

THE BANKRUPTCY SYSTEM

The bankruptcy system is based upon a balancing of competing interests between debtors and creditors and between different classes of creditors. Thus, each decision by a bankruptcy judge depends on the facts presented, the applicable law and, more so than in other judicial proceedings, the "weighing of the equities."

Given the discretion afforded a bankruptcy judge under the United States Bankruptcy Code (the "Code") and interpretive case law, there may be a divergence of opinion on an issue among the various bankruptcy courts. Practitioners often muse that one can find a bankruptcy court case that will support any argument that one may make. While this is an exaggeration, it is important to remember that bankruptcy judges are not uniform in their opinions and their rulings reflect this very delicate balance of interests among the competing parties.

AN OVERVIEW OF THE BANKRUPTCY CODE

The Code provides for five "chapters" - under which a bankruptcy case may be filed. Chapter 9 involves a bankruptcy of a municipality and Chapter 12 involves the filing of a bankruptcy of a "family farmer" as that term is defined in the Code. There are few landlord/tenant cases under these chapters.

The three chapters under which landlord/tenant issues usually arise are:

- **Chapter 7.** A liquidation of all the debtor's assets. A Chapter 7 case may be filed by an individual or a corporation. A trustee appointed by the court inventories assets of the debtor's estate, converts non-exempt assets into cash and distributes the cash to creditors. Upon distribution, assuming there have been no objections to either the debtor's discharge in general or to the dischargeability of a certain debt, the debtor is "discharged" (i.e., generally released from all prior financial obligations).

- **Chapter 11.** A reorganization of any person or entity who or which may be a debtor under Chapter 7. Generally, the debtor continues to operate its business and files a plan providing for payment of all or a certain percentage of its pre-bankruptcy debt. The plan usually provides for a discharge of the debtor once it is consummated. From the landlord's point of view, this type of case involves more issues and requires greater monitoring than a Chapter 7 case because the tenant-debtor will usually remain in possession of the leased premises while it tries to reorganize and the disposition of the lease may be a key to a successful reorganization.

- **Chapter 13.** A reorganization of an individual with regular income (whether from wages, salaries or income from a debtor's proprietorship). This is sometimes called a "consumer reorganization" bankruptcy, but on occasion an individual with a small going business will file a case. The debtor must have no more than \$250,000 in unsecured debts and \$750,000 in secured debts. 11 U.S.C. § 109(e). This figure is adjusted annually for inflation. A Chapter 13 debtor will typically file a plan which will provide payment of a certain portion of the debtor's pre-petition debts to creditors over a 36 to 60 month period. This payment will come from the debtor's future earnings or from the sale of some of the debtor's property. While the plan is in effect, the debtor will make monthly payments to a Chapter 13 Trustee who will then disburse a pro rata share of these payments to the creditors. The debtor is discharged from his debts if the plan is successfully completed. Because of the similarity in treatment of leases in Chapter 11 and Chapter 13 cases, these materials will not give extensive treatment to Chapter 13 cases.

TYPES OF CASES

- **Voluntary Case:** Filed by a Debtor

- **Involuntary Case:** Filed by a Creditor against the Debtor. In order to force a party into an involuntary bankruptcy, the petition must be filed by three or more entities each of which is the holder of a claim that is not contingent as to liability or the subject of a bona fide dispute as to liability or amount, with the claims aggregating at least \$10,000 (again adjusted annually for inflation) or more or if there are less than twelve holders of claims against the Debtor, one or more claim holders who have an aggregate of \$10,000 or more in claims. 11 U.S.C. § 303.

THE PLAYERS

The individual or entity that files for bankruptcy protection is the **Debtor**.

The Creditor or **Claimant** is the one to whom the debtor owes money. Most often, the landlord finds itself in this category. There are different types of creditors:

- **Secured Creditor:** One who has a valid lien against the debtor's property created by a security agreement, landlord's lien, mechanic's lien or other mortgage of property.
- **Administrative Claimant:** One whose debt accrues after the filing of the case (e.g., attorneys, appraisers, accountants, people who provide services after the petition filing, landlords from whom debtor continues to rent).
- **Super-priority Claimant:** An administrative creditor whose claim is paid before other administrative claimants (e.g., creditor who extends credit to the debtor after the petition is filed).
- **Unsecured or General Creditor:** A creditor whose debt arose prior to the filing of the petition. Generally, its claim is the last to be paid. In large reorganization cases, the unsecured creditors may form a committee in order to have a larger voice in the case. In a few cases, the committee may have a stronger voice in the reorganization than the debtor.

The **Trustee** is the one who administers the debtor's estate. Depending upon the type of the bankruptcy, there are different kinds of trustees.

- **Debtor-in-Possession:** In Chapter 11 reorganizations, the debtor assumes the duties of a trustee to operate the business and act in the best interest of the estate.
- **Chapter 11 Trustee:** The court may appoint a qualified individual to operate a business during reorganization for the benefit of the creditors.
- **Chapter 7 Trustee:** In liquidation cases, the court will appoint a trustee to collect the assets of the estate and sell the non-exempt assets for the benefit of the creditors.
- **Chapter 13 Trustee:** In a wage earner or "consumer" reorganization, the Chapter 13 Trustee collects plan payments, disburses funds to creditors and oversees the progress of the case. In large

metropolitan areas, a standing trustee is appointed to administer all Chapter 13 cases.

- **United States Trustee's Office:** In all cases, whether a Chapter 7, 11 or 13, the United States Trustee assigns one of its staff to assist in the supervision and administration of the debtor's estate. The United States Trustee's Office is a branch of the United States Department of Justice.

The **LANDLORD** occupies a unique (and often unappreciated) position in a bankruptcy.

If it is owed money for rent and services prior to the bankruptcy, it is a creditor. If the lease is secured by a lien on assets of the debtor, the landlord may be a secured creditor with a greater priority to payment than a general unsecured creditor.

If the tenant remains on the premises or the trustee uses the premises after the bankruptcy filing, the landlord becomes an administrative claimant by providing services to the estate.

The landlord is usually the holder of an unexpired lease on which the decision must be made to reject (or terminate) it or have it assumed by the tenant-debtor or assigned to a third party. The decision to reject the lease gives rise to special rules governing “rejection” claims.

If the debtor goes out of business, the landlord may find itself as a high-priced storage company for the trustee or secured creditors who have not yet repossessed their collateral. This gives rise to a claim for the use and benefit to the estate or the secured creditors.

In short, the landlord does more than extend credit. It provides a shelter for the business in order for the tenant to service other creditors. The landlord's real property likely continues to accrue tax, mortgage, maintenance, insurance and other obligations for which the landlord may or may not be reimbursed. Thus, a bankruptcy filing may have multiple and varying effects on a landlord, each of which must be carefully analyzed so that the landlord will attain a maximum benefit under less than ideal circumstances.

GOALS OF THE PARTIES

- **Debtor.** A debtor files a bankruptcy in order to obtain relief from its debts and to start life anew unimpaired by past financial problems.
- **Creditor.** A creditor seeks its fair share (along with other creditors) of the debtor's assets. The system is set up to provide equal treatment to creditors of similar status. Often creditors battle among themselves regarding their priority and rights to the debtor's assets.

- **Landlord.** Not only does the landlord want its fair share, it does not want its property tied up (especially if the debtor's lease is below market) in bankruptcy. Careful monitoring of the tenant and the tenant's affairs might put the landlord on notice that a bankruptcy is eminent.

IMPORTANCE OF A TIMELY, PERFECTED AND SUPERIOR CONTRACTUAL LANDLORD'S LIEN

Many states have laws that provide for a statutory landlord's lien on the tenant's property for rent unless the lien is specifically excluded in the lease. It is important to realize that the filing of a bankruptcy case enables a trustee (or debtor-in-possession) to avoid statutory liens. 11 U.S.C. § 545.

Thus, if the landlord is to have a larger say in the reorganization of a debtor or stand in the front of the line to claim the debtor's assets in the event of a liquidation, it must have a contractual landlord's lien perfected by the filing of a UCC-1 Financing Statement in the appropriate state or county office for the filing of such instruments. The contractual landlord's lien will turn an unsecured claim for which the landlord may receive pennies on the dollar into a secured lien which will give the landlord a priority position on the assets of a debtor.

It is also important for the lien to remain superior as to some assets or to some level of liability. A landlord with a subordinate lien or a lien on collateral of little value does it no good. A lender may want the landlord to completely subordinate its lien in order to fund a loan package for a tenant. Upon receipt of a request for a subordination agreement, the landlord must weigh the benefits of retaining its superior lien position against the financial concern of the tenant. If possible, the landlord should try to maintain a superior position as to some assets (inventory, for example) or subordinate its position for all but a certain number of months or years of rent. Realistically, lenders rarely carve out such positions for landlords, but the concept should always be part of a subordination negotiation.

COMMENCEMENT OF THE CASE: THE AUTOMATIC STAY AND ITS EFFECT

A bankruptcy case commences by the filing of a petition by the debtor (if it is voluntary) or by creditors (if it is involuntary). As soon as the case is filed, the automatic stay goes into effect regardless of whether the landlord knows it or not. The automatic stay operates as an injunction or stay against a myriad of actions, applicable to all entities, whether or not those entities or persons actually know of the filing of the case. Historically, the stay has provided the debtor with “breathing space” from creditors’ collection efforts. In addition, the stay provides the debtor with time to propose a repayment or reorganization plan. The automatic stay also protects creditors by permitting the trustee to inventory the estate and provide for an orderly liquidation. Any action undertaken by a creditor toward a debtor while the stay is in effect is voidable (although some circuit courts of appeal have held such actions are void). *In*

re Schwartz, 954 F.2d 569, 571 (9th Cir. 1992); *In re Dunbar*, 235 B.R. 465, 470 (9th Cir. B.A.P. 1999).

Among the actions stayed by 11 U.S.C. § 362 are:

- commencement of any lawsuit, issuance of process, institution of a claim or prosecution of a claim that could have been or was commenced before the filing of the bankruptcy petition;
- the enforcement against the debtor or its estate, of a judgment obtained before the commencement of the bankruptcy case;
- any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
- any act to create, perfect or enforce a lien against property of the estate (however, post-petition acts by a secured creditor necessary to maintain or continue its perfected and secured status are allowed);
- any act to collect, assess, or recover a claim against the debtor that arose prior to the filing of the bankruptcy case; and
- the set off of any debt owing to the debtor that arose before the commencement of the case against any claim against the debtor.

The stay therefore extends to acts against the debtor, the debtor's property, and the property of the bankruptcy estate. *In re Advanced Ribbon & Office Products*, 125 B.R. 259, 263 (9th Cir. BAP 1991). Property of the estate includes "all legal and equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541. It includes any interest in a commercial or residential lease that has not been terminated and some "possessory interests" that continue after lease termination.

Specifically, with respect to a lease that has not been terminated, or has not expired, a landlord may not do any of the following (nonexclusive) acts:

- Threaten a tenant
- Declare a default, including serving a notice to quit the premises
- Perform any self help activities
- Hinder tenant's business in any way
- Sue for unlawful detainer, or continue with a suit
- Terminate lease

- Evict tenant
- Apply security deposit to rent owed
- Lockout tenant
- Foreclose on landlord's lien
- Seize tenant's property
- Shut off utilities
- Show property to prospective tenants
- Move property of tenant who has abandoned premises.

A violation of the automatic stay is disobedience of a federal court order. A violator may be held in contempt, and sued for compensatory and punitive damages. 11 U.S.C. §§105 and 362(k).

Exceptions to the Automatic Stay

On the other hand, the stay does not prohibit such acts as the commencement or prosecution of a criminal action against the debtor; the commencement of, continuation of or enforcement of an action by certain governmental agencies who seek to enforce their police or regulatory powers; or the act of a lessor under a lease of nonresidential property that has terminated by its own terms before or during the bankruptcy case to obtain possession of such property. 11 U.S.C. § 362(b)(10).

This emphasized portion of the above paragraph is especially important to landlords because it means that the landlord may be entitled to seek eviction during the bankruptcy without interference from the stay if the lease has terminated prior to the filing or has expired by its own terms after the filing. [CAVEAT - Since each case is different, and there are different interpretations of the law by different courts, the landlord must be very careful when proceeding with a post-petition eviction without Bankruptcy Court approval.]

The Bankruptcy Code places limits on the automatic stay with respect to individual debtors who are repeat filers. 11 U.S.C. §362(c)(3) (the stay expires 30 days after a bankruptcy filing where a prior case was dismissed within one year before the current bankruptcy filing, absent a court order continuing the stay within the 30 day period); and §362(c)(4) (the stay does not go into effect at all if the debtor had two or more cases pending that were dismissed within the previous year, absent a court order imposing the stay within 30 days after the petition date). While this is not relevant in corporate cases, small businesses owned by individuals may file serial cases to remain in spaces without actually going through the whole bankruptcy process.

The Bankruptcy Code also places limits on the automatic stay with respect to residential leases. The automatic stay does not apply when a landlord seeks to enforce a judgment for possession of residential property if the landlord obtained the judgment before the tenant filed bankruptcy. 11 U.S.C. §362(b)(22). The tenant can invoke the automatic stay for a period of 30 days if it files with the petition and serves upon the landlord a certification under penalty of perjury that: (a) there are circumstances under state law under which the tenant would be permitted to cure the entire monetary default that gave rise to the judgment for possession; and (b) the tenant has deposited with the clerk of the court any rent that would become due during the 30-day period after the filing of the bankruptcy petition. 11 U.S.C. §362(l)(1). In order to preclude the termination of the stay under section 362(b)(22), the debtor must also file with the court and serve upon the landlord within the 30-day post-petition period a further certification stating under penalty of perjury that it has cured the entire monetary default that gave rise to the judgment for possession. 11 U.S.C. §362(l)(2). The Code provides for an expedited hearing if the landlord objects to any certification filed by the tenant. If the landlord objects, the court must hold a hearing within 10 days after the filing and service of the objection. 11 U.S.C. §362(l)(3). If the court upholds the landlord's objection, the stay terminates immediately and the landlord need not seek relief from the stay to recover possession of the property. If the court finds for the tenant, the stay continues to apply.

The Bankruptcy Code also exempts from the automatic stay an eviction action that seeks possession of residential real property "based on endangerment of such property or the illegal use of controlled substances on such property." 11 U.S.C. §362(b)(23). The statute is unclear and will likely invite litigation. It does not define "endangerment" or "illegal use of controlled substances." It also does not clearly indicate whether the landlord must have filed an eviction action for the specific purpose of stopping that activity (rather than for non-payment of rent). The exemption only applies if the landlord certifies that "such an eviction has been filed" or that the tenant "has endangered property" or allowed the use of an illegal controlled substance in the 30-day period before filing the certification. The tenant can reinstate the stay for 15 days by objecting to the landlord's certification, with a hearing to be held in 10 days. 11 U.S.C. §362(m). Given the uncertainty in the language of the statute, it may often be simpler for the landlord to move for relief from the stay.

Motions for Relief From the Automatic Stay

In order to enforce a right stayed by the bankruptcy filing, the creditor must file a motion with the court for relief from the stay. After a preliminary hearing and, if necessary, a full final hearing, the court can lift the stay or modify it if it is shown that the right of the creditor outweighs the need for the stay. Generally the stay issue should be resolved anywhere from 21 to 60 days after the motion is filed.

In the landlord/tenant context, the most frequent grounds for lifting a stay are to allow eviction of a tenant who has defaulted post-petition and to allow drawing down of a security deposit to apply against the pre-petition claim.

HANDLING THE UNEXPIRED LEASE IN BANKRUPTCY - REJECTION, ASSUMPTION, ASSIGNMENT

The following three options are available to any debtor-in-possession (or trustee, if one is appointed), whether or not a shopping center lease is involved. The fourth option specifically concerns the shopping center lease.

- **Rejection of Lease:** If the debtor decides that the lease is burdensome to the estate he will opt to reject the lease. In this case, the lease effectively terminates and landlord can make a claim for damages not to exceed the statutory cap.
- **Assumption of Lease:** If the lease is necessary to the reorganization, the debtor/tenant may undertake the obligations of the lease but must cure all defaults, give adequate assurance of prompt compensation to landlord and give adequate assurance of future performance. BAPCPA makes cure easier with respect to non-monetary defaults as certain non-monetary defaults in real property leases may now be cured after the fact when a debtor wants to assume the lease. 11 U.S.C. §365(b)(1)(A).
- **Assumption and Assignment:** Sometime the debtor determines that the lease is not necessary to its reorganization but is still profitable to the debtor's estate. If this is the case, the debtor may take the lease and assign it to a third party but must satisfy all requirements of assumption (see above) and the assignee must show adequate assurance of future performance.
- **Special Case of the Shopping Center Lease:** Because of the special character of a shopping center (master lease, contractual interdependence among the tenants, fixed hours of operation, common areas, joint advertising, percentage rent clauses, contiguous grouping of stores, special tenant mix, etc.), the Code provides that a tenant-debtor who wishes to assume and assign a lease must prove to the court that (1) the financial condition and operating performance of the proposed assignee is similar to the debtor at the time the debtor became obligated under the lease; (2) any percentage rent due under the lease will not decline substantially; (3) the assumption or assignment is subject to all provisions of the lease and will not breach any other lease financing agreement or master agreement; and (4) the assumption or assignment will not disrupt the tenant mix of the shopping center.

BAPCPA rectified a perceived ambiguity in the Code regarding enforcement of tenant mix provisions by making it clear that provisions of 11 U.S.C. § 365(b)(3) trump any other provisions of § 365. Thus, the courts cannot declare use and exclusivity provisions unenforceable in determining whether a lease can be assumed.

Shopping Center leases are accorded greater protection since the center is often a carefully planned enterprise, and although it consists of numerous individual tenants, the center is planned as a single unit, often subject to a master lease or financing agreement. Under these agreements, the tenant mix in a shopping center may be as important to the landlord as the actual promised rental payments, because certain mixes will attract higher patronage of the stores in the center, and thus a higher rental for the landlord from those stores that are subject to a percentage lease agreement.

LANDLORD CLAIMS

There are three types of claims available to a landlord: secured, unsecured, and administrative. *See* Attachment D for a form Proof of Claim.

- **Secured Claim:** If the landlord has a properly perfected contractual landlord's lien, it is secured. A secured claimant is entitled to receive an amount equal to the value of the collateral securing its lien. Unless the debtor's assets dwindle substantially in value, a landlord with a security interest will probably have a greater chance of having its claim paid in full than an unsecured landlord. One should be aware however, that in most cases landlords may have already subordinated their claim before the bankruptcy filing. If the landlord has a properly perfected contractual landlord's lien, the pre-petition and landlord's rejection damages will be secured and accorded a higher priority than unsecured claims.

- **Unsecured Claim:** If the landlord fails to receive a contractual lien, its claim is deemed to be unsecured. Usually, pre-petition rental falls into this category, as well as the landlord's rejection damages. An unsecured creditor usually receives a very small percentage of its claim because much of the assets of a tenant will be consumed in secured and administrative claims.

Note on Oversecured vs. Undersecured: When the value of the collateral exceeds the amount owed to the creditor, the creditor is deemed to be oversecured. The Code allows an oversecured creditor to recover post-petition interest, and any fees, costs or other charges provided for in the

underlying agreement. It is important to note that these amounts must be recovered out of the collateral.

Conversely, when the value of the collateral is less than the amount owed to the creditor, the creditor is deemed to be undersecured. An undersecured creditor (not receiving any administrative rent) should ask that the stay be lifted as soon as possible, in order to maximize its recovery in the bankruptcy.

- **Administrative Claim for Rent.** After the filing of the petition, the landlord is entitled to payment of rent and other obligations of the lease, (as well as payment for services which benefit the estate such as storage, maintenance of premises, etc.). The landlord has a right to current payment of rent during the administrative period, although there is some authority that if the landlord does not press this right in a timely manner, it may not be able to recover this rent until all of the other administrative claims are paid.
- **Administrative Claim Prior to Rejection of the Lease.** Until the lease is rejected by court order or by operation of law, the landlord is entitled to administrative rent in the amount reserved in the lease. The majority of cases also allow the landlord an administrative claim to 120 days after the filing of the Petition (depending on when the case was filed) without the necessity of a hearing or a showing of benefit to the estate.
- **Administrative Claim After Rejection of Lease.** There may be some circumstances in which the lease is rejected or otherwise terminated and the tenant continues to occupy the premises. In such cases, the landlord is entitled to rent for the debtor's use of the premises which benefited the estate.
- **Administrative Claim after Assumption and then Rejection of Lease.** Prior to BAPCPA, a landlord had an unlimited administrative claim when a lease was assumed by a debtor and then rejected. BAPCPA capped this claim at two years of rent. 11 U.S.C. §503(b)(7).
- **Property Tax Claims.** While there is a great deal of disagreement among the courts, one would think that real estate taxes which became due after the filing of the petition are administrative expenses. Thus, if the lease recites that taxes are due upon billing to tenant and the billing date is after the filing of the petition, the landlord should recoup all real estate taxes reflected by that bill. However, some courts may prorate the taxes between pre- and

post-petition dates even if the bill was due post-petition. Remember, taxes due prior to the petition date are considered pre-petition general non-priority debts.

- **Claims for Environmental Clean-Up and Restoration Costs.** There are several lines of cases on the availability of an administrative claim for environmental clean up. One line holds that an administrative claim is only available if the contamination occurred post-petition. The better rule for landlords is contained in those cases which hold that any pre-petition environmental damages caused by property of the estate will enjoy administrative expense priority as long as actual costs are incurred post-petition to remedy the damage, but if no costs are incurred, the claim will be a general claim against the estate.
- **Claims Arising from Rejection of Lease.** If the lease is rejected by operation of law (meaning that the debtor did not exercise its right within the time limits set forth) or if the debtor voluntarily rejected the lease, a special claim limit is enforced on damages resulting from the breach that arises by such rejection. As pointed out previously, this claim may be either secured or unsecured depending upon the existence of a perfected contractual lien.

CALCULATION OF THE CLAIM

The Code places a ceiling (commonly known as "the cap") on a claim for future rent by a lessor resulting from rejection of the lease of either the greater of (1) the rent reserved in the lease without acceleration, for one year; or (2) fifteen percent (15%) not to exceed three years of rent for the remaining term of the lease. 11 U.S.C. § 502(b)(6).

Both of these alternatives are usually measured from the date the petition is filed. For a short term lease (i.e. under five (5) years, the landlord will receive the most by computing the rental for one year. If the rent called for in the lease is constant for the entire term of the lease, the fifteen percent provision will yield a higher damage claim amount only if the remaining lease term exceeds six and two-thirds (6 2/3) years.

The first step in calculating damages for a claim is to determine how much rent or other damage was owed prior to the filing of the case. This amount is not subject to the § 502(b)(6) cap. The landlord may then use the measure of damages provided under the lease or by common law to calculate future damages. In many instances, this measure is the present value of the future rental stream (components of rent are usually defined in the lease) less the fair market value of the lease, also reduced to present value. In addition, most leases provide for the landlord to recover the cost of commissions and tenant improvements for a new tenant.

Since damages subject to the cap are determined by state law, the landlord must reduce its claim by any amount by which it has mitigated its damages. Also, the landlord should probably reduce its damages by any security deposit it holds (although the stay must be modified to allow it to take the deposit).

Once the landlord goes through this exercise, it can compare its future damages to the cap and file a claim for either the capped amount or the damages if they fall under the cap. Remember, past damages are in addition to the capped amount.

Since the landlord's claim arising from rejection of the lease is severely limited, courts generally hold that post-petition rent received by the landlord from either the debtor or a third party to whom the property has been relet, should not be applied in satisfaction of the landlord's maximum amount allowed by law.

In some cases a claims bar date will be set early, but in more complex cases, the court will set a bar date depending on the circumstances. Usually, the "standard" bar date will not apply to future damages of landlords whose leases have not been rejected by the time of the general bar date. The landlord may have to file a claim for past damages by the original bar date and an amended or new claim for rejection damages. The latter date is usually 30 days after rejection, but it depends on the order from the court or plan of reorganization.

SOURCES OF COMPENSATION OTHER THAN THROUGH CLAIMS PROCESS

A landlord should leave no stone unturned in trying to make the best of a tenant's bankruptcy. Below are other sources of compensation which should be considered by the landlord of a bankrupt tenant.

- **Security Deposit:** A security deposit held by a landlord on a rejected lease must be applied against the rejection damages or other pre-petition claim. In order to draw down the security deposit, the landlord must seek permission from the Court by relief from the automatic stay.
- **Letter of Credit:** A letter of credit issued at least ninety (90) days prior to a bankruptcy filing is very advantageous to a landlord, since it is well established that a letter of credit and the proceeds therefrom are not property of the debtor's estate. Recent litigation in this area indicates that if a landlord has a letter of credit in excess of what should be its claim under § 502(b)(6), the landlord should forego filing a claim and look to the institution that issued the letter of credit for compensation. *See, In re Stonebridge Technologies*, 2005 U.S. App. LEXIS 24024 (5th Cir. 2005).

- **Third Party Guaranty:** Sometimes the landlord requests a third party guaranty either from a principle of the tenant or from a parent company of the tenant. Generally, and as long as the guarantor is not a party to the bankruptcy, the stay does not apply against guarantors of a secured debt. The reasoning behind this general rule is that guaranties are obligations of third parties and, as such, are not property of the estate. Although some jurisdictions allow courts enjoin the enforcement of guaranties, most jurisdictions allow a creditor to proceed against a guarantor without danger of violating the automatic stay.

- **Trustee Sales:** Occasionally, the bankruptcy case fails for the tenant-debtor and its assets must be sold. A trustee will be appointed and he/she may attempt to use the leased premises as the site of the sale. The disruption of the business of other tenants, the violation of lease provisions prohibiting auctions or other sales on the premises and the potential injury to the premises or others resulting from an unusual influx of people on the premises should cause landlords to be very hesitant when such a sale is proposed. Unfortunately, the bankruptcy cases usually allow such sales even in violation of a lease provision. However, a landlord may be in a position to negotiate a "fair deal" for such use of the premises which may include a percentage of receipts, additional rent for the unusual circumstances or other additional considerations.

- **Recovery from Secured Creditor:** Occasionally, a secured creditor may have property on the leased premises which has been abandoned by a tenant-debtor or which is under control of the trustee. With the proper agreement in place, the landlord may recover reasonable compensation from the secured party until that party is able to retrieve the collateral and remove it from the premises.

- **Other Remedies of Landlord in Bankruptcy Court:** A creditor who senses that a debtor is not taking its fiduciary duty as a debtor-in-possession seriously or who believes that the debtor has been dishonest before or after the filing of the bankruptcy may undertake several remedies. The creditor might initiate an investigation by the United States Trustee or United States Attorney if fraud is suspected or might move for dismissal of the case or object to the discharge of the debtor.

In addition, should the creditor feel that its interests are not being adequately protected, it might move for relief from the automatic stay in order to foreclose on its security interest or in order to repossess the leased premises.

The creditor might move for an order prohibiting the use of cash collateral or move for a conversion of the case to liquidation.

SOURCES OF PAYMENT TO THE ESTATE (AND FROM THE LANDLORD)

In some instances, the tenant may have paid the landlord a lump sum of past due rent just prior to the filing of a bankruptcy case or paid the rent of another party just prior to filing. Depending on the circumstances these payments may be a preference under 11 U.S.C. § 547 or a fraudulent transfer under 11 U.S.C. § 548.

A preference is a transfer made within 90 days of the bankruptcy filing, unless the landlord establishes it was made in the ordinary course of business and was made according to ordinary business terms in the industry. However, on all cases filed after October 17, 2005, the "and" referenced in the proceeding sentence becomes an "or" making it easier for a landlord to prove a defense if it has chronically accepted late rent. In a non-consumer bankruptcy case, a payment of less than \$5,000.00 is not an avoidable transfer. See, 11 U.S.C. § 547.

In addition, to the extent that the landlord provides "new value" to the tenant as a result of the payment, the transfer is not a preference.