

## NEGOTIATE OR LITIGATE: LANDLORD'S DILEMMA WHEN FACED WITH A DEFAULTING TENANT

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When a tenant defaults on its lease obligations, the landlord has contractual and statutory remedies (including the ability to file an unlawful detainer ("UD") action or other litigation).<sup>1</sup> Additionally, the landlord may have the right under its lease to compel mediation or arbitration. Notwithstanding these rights, landlords in today's softer commercial real estate market may consider attempting to resolve problems with struggling tenants before they rise to the level of a default under the lease. The landlord should evaluate how to best respond to such tenants in light of current market conditions. Landlords may even want to assist a defaulting tenant to cure its default without having to resort to litigation. When the real estate market is strong, a landlord may want to declare a tenant in default so that it can lawfully evict the tenant and replace it with a more credit worthy tenant or a tenant willing to pay higher rent. In a weak real estate market, with higher vacancy and lower rental rates, it may be in the landlord's interest to attempt to retain its struggling tenant as opposed to letting the premises sit vacant for a prolonged period of time. This article addresses the landlord's various options; from negotiating with tenants in a weaker real estate market to either avoid defaults or resolve such defaults and continue the tenancy to filing a UD action to regain possession of the premises from a defaulting tenant.

### EVALUATE BEFORE YOU NEGOTIATE OR LITIGATE

The landlord generally has several choices when dealing with a defaulting tenant. A landlord's first reaction may be to attempt to take matters into his own hands by exercise "self-help" to remove the tenant. Under the common law, a landlord had a right to "self-help." The UD statute replaced this common law remedy which sometimes led to violence between landlords and tenants. *Daluiso v. Boone* (1969) 71 C2nd 484,495. Today, even if a landlord has legal title to the premises, he may not resort to self-help.<sup>2</sup> A tenant, even one that is unlawfully remaining in the premises, is not treated as a "trespasser" and thus is entitled to peaceful and quiet possession until a legal eviction process awards possession back to the landlord. *Four Seas Investment Corp. v. International Hotel Tenants' Ass'n* (1978) 81 CA3d 604, 612.<sup>3</sup>

Given the potential for civil (and even criminal<sup>4</sup>) liability for unlawful forcible entry or detainer, the landlord is forced to choose between litigating a dispute or attempting to negotiate a solution with its tenant. Whether a landlord chooses to negotiate with a defaulting tenant prior to or after the filing a lawsuit, one thing remains the same -- the preparation that must be done before the landlord ever sits down to the negotiation table. The landlord must first decide if it is even willing to negotiate with the defaulting tenant. If the landlord chooses to negotiate with the tenant, the landlord must then determine the tenant's financial condition. To that end, the landlord should request updated financial information from the tenant, including updated financial statements, credit reports, tax returns, and account information for all tenant bank accounts together with any other information the landlord reasonably believes will assist it in ascertaining the tenant's true financial condition. This will help the landlord determine if the tenant's difficulty in paying rent is the result of a short term financial problem or an indication of bigger problems, such as a potential bankruptcy. This financial information should be attached to or referenced in any lease amendment, accompanied by a representation from the tenant that the information is "true, correct and complete" in all material respects.

Next, the landlord must determine what it is trying to achieve in the negotiation and then select an approach that will further that goal. Some of the questions the landlord must ask and answer include:

- (1) Should the landlord attempt to retain the struggling tenant?
- (2) If so, what concessions is the landlord willing to offer to assist the struggling tenant?
- (3) What should the landlord ask for in return for such concessions?
- (4) Will the landlord's lender allow the landlord to amend or modify the lease?
- (5) How will the retention of a financially troubled tenant or any related concessions reflect on the value of the building in the context of a future refinance or sale?
- (6) What is the likelihood that the defaulting tenant will be able to meet its lease obligations in the future if a compromise is reached to allow such tenant to remain in the premises?

- (7) Should the landlord attempt to replace the defaulting tenant?
- (8) If so, is it possible for the landlord replace the existing tenant with another tenant that is as good as or better than the existing tenant?
- (9) How long will it take to replace the existing tenant?
- (10) What effective rental rate will this new tenant be willing to pay in a down market?
- (11) What is the total cost to replace the existing tenant (consider broker commissions, attorneys' fees, costs of removal of existing tenant improvements, construction of new tenant improvements, free rent and other concessions)?
- (12) If the landlord has suffered additional damages should it pursue legal action against the defaulting tenant after it has found a replacement tenant?

### **LITIGATION AS LEVERAGE TO AID IN NEGOTIATIONS**

Whether the landlord files a UD action or an independent civil action for damages, there are always pros and cons to litigation. The advantages of litigation include that it can end prolonged negotiations and tenant stall tactics and provide substantial negotiating leverage to the landlord. Filing will also start the court's clock running to legally evict the tenant under applicable law and may increase the likelihood of there being assets to collect if the landlord wins a judgment. Among the disadvantages of litigation are that it will consume time and money and it may destroy the relationship with the tenant.

Notwithstanding its disadvantages, most sophisticated landlord's will, as a matter of policy, serve a three day notice and file a UD action at the earliest possible opportunity to incentivise a tenant to operate in good faith and quickly conclude negotiations. A UD action is an expedited statutory procedure that allows a landlord to regain possession of the leased premises occupied by a tenant or other occupant whose right to possession has terminated (i.e., due to an uncured default). Even if the landlord has no desire to regain possession of the premises, the expedited nature of this procedure forces a tenant to act quickly and reasonably during the negotiation process. This way, if negotiations with the tenant break down or if the tenant is not negotiating in good faith or is using the negotiation process to stall, the clock will run during the entire negotiation process and the landlord will not lose valuable time if it must thereafter evict the tenant. The concern of damaging the relationship between the landlord and tenant or of halting negotiations is usually eliminated once it is explained to the tenant that the litigation process has been instituted as a matter of routine to preserve landlord's rights and to insure the negotiations stay on track.

### **NEGOTIATION**

Even in a down real estate market, the landlord has a number of options when negotiating with its tenant, including the following:

(1) Inaction Not an Option.

Unless the commercial lease includes a well drafted non-waiver clause, landlord's failure to act upon a tenant's default may be deemed a waiver of landlord's right to declare future defaults. In addition, a landlord's failure to force tenant to cure its default or otherwise address the problem can send a dangerous message to other tenants that the landlord does not enforce its leases.

(2) Keep it Confidential.

Before settlement discussions even begin, the landlord should insist that the tenant sign a confidentiality agreement. This will help to prevent other tenants from finding out about any compromise the landlord has made and thus prevent numerous similar requests from other tenants.

(3) Quid Pro Quo Negotiations.

A defaulting tenant may attempt to renegotiate only that portion of the lease which it is having difficulty (i.e., rental rate). The landlord should not let the tenant establish the rules of the game. The landlord should determine it has obtained as much as possible from the tenant in exchange for the tenant's requests. Landlord should also carefully review all lease documents to determine what concessions were originally given to the tenant and determine which of them can be taken back or renegotiated.

(4) Postpone or Restructure Rental Payments.

If the tenant is facing a temporary cash-flow problem, the landlord may consider giving the tenant a temporary period of free-rent or reduced rent instead of a permanent reduction in rent. The landlord may attempt to recover

this lost rent by increasing the term or increasing the rental rate in the later years of the term when the tenant will hopefully not have the same cash-flow concerns.

(5) Extend the Term.

A landlord may be reluctant to extend the term for a tenant who is not able to live up to the obligations of the original lease, but assuming the tenant is financially stable but unwilling to continue paying what it believes is “above-market” rent, it may be advisable for the landlord to have the tenant agree to add years to the term in exchange for short term rental concessions. Also, if a tenant later defaults, the period of time for which the landlord can collect rent will be increased.

(6) Ask for Additional Security.

The landlord should ask for an additional letter of credit, increased security deposit or a surety bond. If the tenant’s financial information reveals tenant is unable to post additional security, consider obtaining personal or parent guarantees.

(7) Secure Lease Obligations.

If the landlord did not obtain sufficient collateral or security when the lease was first entered into, the landlord should use its increased leverage to obtain such security during the negotiation period. The landlord will thus become a secured creditor if the tenant files for bankruptcy. The landlord should consider obtaining an interest in any asset which is available. For example, there may be equity in the tenant’s furniture, fixtures and equipment or in its intellectual property.

(8) Consider Creative Solutions.

The landlord should attempt to look for all potential ways to bridge the gap with the tenant. For example, landlord may be willing to accept “in kind” services or goods from the tenant in lieu of rent. The landlord should also consider accepting stock, options or warrants in the tenant company in lieu of rent or holding an interest bearing note payable after tenant receives further financing. It may be possible to relocate the tenant to inferior space within the landlord’s portfolio of space or require tenant to reduce the total amount of space it leases as opposed to terminating the lease altogether.

### **ONCE SETTLEMENT IS REACHED**

When the landlord has reached an agreement with the tenant, the landlord and tenant should memorialize their agreement in a confidential amendment to the lease. The landlord should also insist that the tenant agree to a stipulated judgment for the amount of the default (plus interest) rather than a dismissal of any pending action against the tenant. This will act as a strong incentive for tenant to live up to its obligations for the remainder of the lease term and will save the landlord time and money because the landlord will not need to sue the tenant to collect on the judgment.

The landlord should include in the lease amendment language stating that all of the concessions given to the tenant in the amendment shall be withdrawn in the event of any future default. This will prevent the tenant from obtaining a reduction in rent or other lease obligations, then defaulting again and thereby avoiding the full amount of damages that the tenant would have been liable for under the original lease.

### **LITIGATION AS LAST RESORT**

If negotiations fail, the landlord’s only other alternative is litigation.<sup>5</sup> If the tenant is still in possession, the landlord can pursue an expedited legal procedure of unlawful detainer to regain possession of the premises.<sup>6</sup> A landlord can’t begin such a lawsuit without first legally terminating the tenancy. This means landlord must provide the tenant with a legally adequate written notice.<sup>7</sup> If the tenant doesn’t move out or cure its default after receipt of such notice, the landlord can then file a UD lawsuit to evict the tenant.

Courts are required to give UD actions priority (Code Civ. Proc. § 1179) and must set trial of a “contested” UD not more than 20 days after landlord’s request for trial setting (Code Civ. Proc. § 1170.5). In reality, the 20-day deadline is rarely (if ever) met. Because of court backlog, the UD trial typically is not set for 30-60 days. In addition to the court backlog, a tenant has a number of delay tactics at its disposal. If the tenant decides to mount a defense, it may add months to the process. A tenant can point to technical defects in the notice or the UD complaint (or improper service of either) in an attempt to delay the case.

Tenant will have only five days to respond in writing to the landlord’s complaint. A tenant may choose to demur to the complaint or move to “strike” the complaint instead of answering.<sup>8</sup> The tenant may also answer the complaint and assert various affirmative defenses.<sup>9</sup>

Once the complaint has been answered, and the matter is “at issue,” the court will hold a hearing at which the parties can present their evidence and explain their case. The tenant has a right to a jury trial, and either party can request one. If the tenant has a good defense, the court will not evict the tenant. If the court decides in favor of the tenant, the tenant will not have to move, and the landlord may be ordered to pay court costs. The landlord also may have to pay the tenant’s attorney’s fees, if the lease contains an attorney’s fee clause.<sup>10</sup>

If the landlord prevails at the UD hearing, the court may award the landlord damages (unpaid rent), court costs and attorney’s fees. The court will issue a writ of possession which orders the sheriff to physically remove the tenant from the premises, but gives the tenant five additional days from the date that the writ is served to leave voluntarily.

## CONCLUSION

Negotiation as opposed to litigation (or in some cases contemporaneously with litigation) can often accomplish the goal of salvaging a troubled tenancy in a weaker commercial real estate market. The landlord should carefully prepare for and conduct creative negotiations from a position of strength to allow the landlord to continue the tenancy (and the payment of rent). If negotiations fail, landlord should retain experienced legal counsel to insure that the technical requirements of the law are met and to increase the likelihood that tenant will be removed from the premises as quickly as possible.

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<sup>1</sup> The unlawful detainer and forcible entry and detainer provisions can be found at Cal. Code Civ. Proc. §1159 *et seq.*

<sup>2</sup> See *Glass v. Najafi* (2000) 78 Cal.App.4<sup>th</sup> 45, 48.

<sup>3</sup> “Forcible entry” and “forcible detainer” are prohibited by statute. Cal. Code Civ. Proc. §§1159 and 1160.

<sup>4</sup> Cal. Pen. Code § 418 makes it a misdemeanor to use, encourage or assist another to use “any force or violence in entering upon or detaining any lands or other possessions of another, except as allowed by law.” This statute has been found to apply to landlords. *Daluiso v. Boone* (1969) 71 Cal.2d 484, 499.

<sup>5</sup> Many leases contain arbitration and/or mediation provisions. Well drafted leases, however, will “carve-out” unlawful detainer from the mediation/arbitration provisions of the lease, allowing landlord to use the courts to obtain expedited resolution of these types of disputes. The following language should be inserted into any arbitration provision of landlord’s form lease:

“ANY CLAIM OR CONTROVERSY OF WHATEVER NATURE INCLUDING BUT NOT LIMITED TO THE ISSUE OF ARBITRABILITY (EXCEPT FOR ANY MONETARY DEFAULTS BY TENANT, WHICH SHALL BE SUBJECT TO THE CALIFORNIA UNLAWFUL DETAINER STATUTE) ARISING OUT OF OR RELATING TO THIS LEASE, OR THE BREACH THEREOF, SHALL BE SETTLED BY FINAL AND BINDING ARBITRATION.”

<sup>6</sup> A UD action is used to remove a tenant (i) that holds over after a fixed term lease has expired, (ii) after service of notice terminating a month-to-month tenancy (Code Civ. Proc. §§ 1946 and 1161(1)), (iii) after notice terminating a tenancy at will or (iv) after breach of a lease beyond all notice and cure periods and proper service of a 3 day notice (Code Civ. Proc. § 1161(3)).

<sup>7</sup> California laws set out very detailed requirements to end a tenancy. Specific types of termination notices are required for different types of situations, and California has its own procedures as to how termination notices and eviction papers must be written and delivered (“served”). The landlord initiating the eviction process is advised to consult an experienced UD attorney before beginning this process.

<sup>8</sup> Grounds for a demurrer include lack of legal capacity to sue, defect or misjoinder of parties, premature filing and insufficient pleading of key facts (description of premises, notice, tenant in possession). Grounds for a motion to strike may be filed to strike any irrelevant, false or improper matter or for lack of verification.

<sup>9</sup> Affirmative defenses in a UD matter are limited but include landlord fraud, breach of the Covenant of Quiet Enjoyment, setoff for preexisting debt, equitable defenses (oral lease, no landlord-tenant relationship, landlord bad faith, landlord’s failure to accept suitable alternative security, landlord acquiescence to breach), waiver or estoppel, breach of express promise to repair, breach of implied warranty of habitability, retaliatory eviction and discriminatory Eviction under Unruh Civil Rights Act

<sup>10</sup> Cal. Civ. Code § 1717. See, also, *Trope v. Katz* (1995) 11 Cal.4th 274