4th Civil No. G026984

IN THE COURT OF APPEAL
STATE OF CALIFORNIA
FOURTH APPELLATE DISTRICT
DIVISION THREE

VALLELY INVESTMENTS, L.P.,
a California limited partnership,

Plaintiff/Appellant,

vs.

BANCAMERICA COMMERCIAL CORPORATION,
a Pennsylvania corporation; and DOES 1 through 50, inclusive,

Defendant/Respondent.

APPELLANT'S OPENING BRIEF

Appeal from the Orange County Superior Court
Honorable Robert D. Monarch, Judge
Case No. 792718

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INTRODUCTION

The trial court erred in granting summary judgment because it failed to recognize the two distinct sets of duties created by a lease: privity of estate and privity of contract. The first refers to a tenant's obligations arising by operation of law while the tenant is in possession. The second refers to a tenant's contractual obligations arising under a lease, which follow the tenant even if it is dispossessed before the end of the lease term. By mistakenly applying the rules that govern the first set of obligations to events arising under the second, the trial court wrongly stripped a landlord of its contractual rights against its former tenant.

Vallely Investments, L.P. leased its land to Balboa Landing, which took out a construction loan secured by a trust deed on its leasehold interest. When Balboa Landing later assigned the ground lease to respondent Bancamerica Commercial Corporation ("BACC"), BACC came into privity of estate with Vallely. BACC also came into privity of contract with Vallely when, in the recorded assignment, BACC agreed "to faithfully observe, perform and fulfill all of the terms, covenants and conditions and obligations required to be observed, performed and fulfilled by [Balboa Landing]." (Joint Appendix ["JA"] 114.)

BACC's privity of *estate* with Vallely ended when Balboa Landing's lender foreclosed, extinguishing BACC's right to possession. But the foreclosure had no effect on BACC's privity of *contract*, which continued to bind BACC.

When a subsequent lessee abandoned the lease, Vallely turned to BACC to fulfill its obligations. After BACC refused, Vallely filed a declaratory relief action. The trial court, mistakenly believing that the lender's foreclosure extinguished BACC's obligations to Vallely along with its right to possession, granted summary judgment to BACC and denied it to Vallely. Since Vallely is entitled to judgment as a matter of law, the judgment must be reversed with directions to enter judgment for Vallely.

STATEMENT OF FACTS

The admitted evidence is not in dispute and is summarized below. This case involves the application of legal principles to that evidence. In its cross-appeal notice, BACC indicates that it will challenge the exclusion of evidence pertaining to BACC's purported intentions when it assumed the Lease. That excluded evidence and the propriety of the court's ruling is separately discussed in Section II.A.3.

A. The Ground Lease.

1. The Lease's origins and the parties.

In 1978, the Vallely Family Trust leased its Balboa property to the Fun Zone to develop as a commercial center. (JA 8.) By 1986, Balboa Landing ("Balboa") had taken over as the developer. (JA 8-9.) That same year, Balboa obtained a $7 million loan from BA Mortgage and International Realty Company ("BA Mortgage"), a Bank of America-related entity, secured by a deed of trust on the ground lease. (JA 361-387, 910.)

Also in 1986, the parties amended and restated the ground lease ("the Lease"), which is the subject of this litigation. (JA 8-112.) The Lease provides that all leasehold mortgages are "subordinate to the rights of the Lessor" (JA 67 [Article 12.4]), and that the Lessor shall always have "paramount title" over all liens (JA 46-47 [Article 8.1], 66 [Article 12.2]). The trust deed was amended to reflect its subordination to the Lease (JA 381), and Vallely has since agreed to subordinate the Lease to the trust deed (JA 502).

Real Estate Collateral Management Company ("RECMC") succeeded to BA Mortgage's interest after 1989. (JA 333.) We refer to both BA Mortgage and RECMC collectively as "RECMC." Vallely Investments, L.P. succeeded to the Vallely Family Trust's interests in 1992. (JA 553-554.) We refer to the Vallely Family Trust and Vallely Investments, L.P. collectively as "Vallely."

2. The lessee's right to assign the Lease to a party that agrees to assume the Lease covenants.

The Lease permits the lessee to freely transfer or assign the Lease. (JA 65-66 [Article 12].) The assignee, however, must accept and assume all the Lease terms and covenants. (JA 66 [Article 12.2].) Any assignment is "void and ineffective" to the extent the lessee attempts to convey anything less than a complete assignment. (JA 76 [Article 18.1].) The covenants of the Lease bind all assignees the same as if they were named parties to the Lease. (JA 90 [Article 26.1].)

3. The lessee's right to mortgage its leasehold estate and a foreclosing lender's exculpation clause.

The Lease gives a lessee the right to mortgage its leasehold estate. (JA 66-67 [Article 12.4].) If the lender forecloses on its security interest and becomes the owner of the leasehold estate (either by purchasing the Lease in a foreclosure sale or by receiving the Lease by assignment in lieu of foreclosure), it is exempted from the condition that an assignee assume the Lease. Rather, the lender's liability is expressly limited to that which arises under privity of estate—i.e., it is liable only as long as it holds the property. (JA 70 [Article 13(e)].)

B. Balboa Assigns The Lease To BACC Before RECMC Forecloses On Its Trust Deed, And BACC Expressly Assumes The Lease Obligations.

Around August 1988, Balboa defaulted on its loan from RECMC. (JA 394.) When RECMC began foreclosure proceedings, Balboa filed for bankruptcy protection, staying the foreclosure. (JA 390, 397, 698.) RECMC and Balboa subsequently worked out what BACC describes as a "complicated transaction involving multiple documents negotiated between

sophisticated business entities." (JA 590.) They did so without Vallely's knowledge. (JA 590-591, 725, 789.)

The RECMC-Balboa workout is documented in a "Stipulation Re Assumption and Assignment Of Lease And Automatic Stay" ("Assumption Stipulation"). (JA 390-425.) Under the agreement, Balboa was to assign the Lease in its entirety to BACC, a wholly-owned Bank of America subsidiary. (JA 397-399, 406-408, 699, 796, 910.) BACC would then manage the property while RECMC completed a non-judicial foreclosure sale. (JA 401.)

The deal was allegedly structured this way to serve four specific purposes: (1) to extinguish mechanics' liens; (2) to protect RECMC's title insurance; (3) to provide for the property's upkeep pending the trustee's sale; and (4) to eliminate the possibility of a deficiency judgment against Balboa. (JA 592-594, 892-894.) According to BACC, a deed in lieu of foreclosure would not have fulfilled these purposes. If RECMC had taken an assignment directly from Balboa, RECMC's interests under the trust deed and Lease could merge, and RECMC would take the property encumbered by substantial mechanics' liens. (JA 892-893.) But if Balboa assigned the Lease to BACC, RECMC could wipe out these junior liens by foreclosure. (*Ibid.*) In the meantime, BACC could maintain the property in good repair. (JA 892.)

Pursuant to the Assumption Stipulation, in April 1989 Balboa and BACC executed and recorded an "Assignment of Leasehold Interest" in which Balboa assigned BACC "all of the Assignor's right, title and interest as lessee in and to the Ground Lease" and "any and all other right, title or interest held by Assignor in and to the Property." (JA 113-119 ["the Assignment"].) The Assignment was made "expressly subject to the lien of" the construction trust deed. (JA 114.) In the Assignment, BACC "covenant[ed] and agree[d] to and with Assignor, to faithfully observe, perform and fulfill all of the terms, covenants and conditions and obligations required to be observed, performed and fulfilled by Assignor, as lessee under the Ground Lease." (*Ibid.*)

C. Following RECMC's Foreclosure, Another Assignee Defaults And Petitions For Bankruptcy.

In June 1989, RECMC foreclosed on the trust deed and purchased the Lease at the trustee's sale. (JA 191-195.)

In July 1994 RECMC sold the Lease to Edgewater Place, Inc. ("Edgewater"). (JA 120-128.) The rent for the year beginning November 1, 1995 ("1996 rent") was due in one lump-sum payment on November 1, 1995. (JA 16 [Article 3.1].) However, as a one-time concession for Edgewater's making some needed repairs, Vallely agreed to accept the 1996 rent in monthly installments. (JA 439, 443, 445.) Vallely and Edgewater executed an addendum to the Lease ("Edgewater Addendum") that documented this modification and their intention that all other rent would be payable in accordance with the Lease. (JA 443-446.)

Edgewater defaulted on the rent in May 1996. (JA 725.) That was when Vallely first learned of Balboa's assignment to BACC. (JA 725, 789.) In spring 1997, Edgewater filed a chapter 11 bankruptcy petition. (JA 181-182.) Edgewater failed to assume or reject the Lease, and the Lease was therefore deemed rejected by order of the bankruptcy court in June 1998. (JA 150-154.) Edgewater abandoned the property around August 1998; Vallely has since been managing the property. (JA 554, 741.)

D. Trial Court Proceedings.

1. Vallely files its declaratory relief action.

In April 1998, while Edgewater was in bankruptcy, Vallely filed a declaratory relief action against BACC. (JA 1-128.) Vallely asked the court to declare "that [BACC] is an assignee of the Ground Lease pursuant to the Assignment of Leasehold Interest, and that [BACC] expressly assumed the obligations of the Ground Lease and is liable for the obligations of the Ground Lease for the remainder of the lease term." (JA 7.)

In May 1998, BACC filed a general denial and raised fourteen affirmative defenses. As relevant here, they were: (a) RECMC's foreclosure on its trust deed terminated any ongoing obligations BACC may have had under the Lease (second defense); (b) the RECMC-Edgewater sale was a novation that discharged BACC (eleventh); and (c) BACC was a surety whose Lease obligations were exonerated (twelfth). (JA 129-136.)

2. The three summary judgment motions.

a. The trial court denies BACC's initial summary judgment motion, concluding that Edgewater's bankruptcy did not affect BACC's Lease obligations.

BACC moved for summary judgment on the ground that Edgewater's deemed rejection of the Lease in bankruptcy proceedings terminated BACC's obligations. (JA 137-156.) After the court granted the motion (JA 221-223), Vallely moved for a new trial (JA 224-226). In that proceeding, BACC raised its eleventh affirmative defense, arguing that the assignment of the Lease to Edgewater constituted a novation that released it from any Lease obligations. (JA 278-280.)

The trial court reversed itself, concluding that "the bankruptcy of Edgewater Place, Inc. does not affect the rights of plaintiff and lessor [Vallely] against [BACC]" and that the assignment of the Lease to Edgewater "does not relieve [BACC] of whatever obligations it may or may not have under the Ground Lease." (JA 323-325.)

b. The trial court grants summary judgment to BACC and denies it to Vallely on the ground that RECMC's foreclosure terminated BACC's Lease obligations.

Six months later, Vallely moved for summary judgment on the ground that BACC expressly assumed the Lease obligations and continued to be bound by them. (JA 547-555.) In opposition, BACC submitted a declaration by David Granoff, a lawyer for BACC and RECMC, who purported to testify to the reasons the BACC-RECMC workout was structured to include BACC. (JA 695-700, 702-703, 793-796.) Vallely objected to the declaration on various grounds, including lack of foundation, hearsay, and impermissible opinion. (JA 777-779, 807-809.)

BACC also re-urged its eleventh affirmative defense that RECMC's conveyance to Edgewater constituted a novation. (JA 603-605.) Finally, BACC argued that it was RECMC's "agent" and therefore entitled to the protection of the Lease's Article 13(e), which limits liability of leasehold mortgagees to the term of their possession. (JA 596-598.)

At the same time, BACC again moved for summary judgment, this time on (a) its second affirmative defense that RECMC's foreclosure terminated any ongoing obligations BACC might have had under the Lease, and (b) its twelfth affirmative defense that the Edgewater Addendum was a material modification that exonerated BACC as a surety. (JA 326-347.)

In supplemental briefing, BACC renewed its unsuccessful argument that Edgewater's deemed rejection of the Lease in bankruptcy terminated BACC's Lease obligations. (JA 895-899.) BACC also argued that if it had assumed the Lease obligations for the full Lease term, that assumption would be void as ultra vires under federal banking law. (JA 899-900.)

As part of its supplemental briefing, BACC filed a declaration by Eric Forsberg, who provided additional documents concerning the RECMC-Balboa workout. (JA 908-913.) Vallely objected. (JA 924-925.)

The court granted BACC's summary judgment motion and denied Vallely's motion. (JA 1036-1038.) Finding that the relevant facts were not

in dispute and that it was presented with a pure legal question, the court concluded that the Assignment, read in conjunction with the Assumption Stipulation, "make[s] it clear that the assignment is subject to the Construction Deed of Trust" and that RECMC's foreclosure "terminated the interest of [BACC] in connection with the lease resulting from the assignment," citing *Dover Mobile Estates v. Fiber Form Products, Inc.* (1990) 220 Cal.App.3d 1494. (JA 1037-1038.)

The court sustained Vallely's objections to Granoff and Forsberg's declarations, ruling that BACC's intent was immaterial to the issue of the foreclosure's legal effect, which was the basis for its decision. (RT 70-72.)

3. Judgment and appeal; statement of appealability.

The judgment was filed on January 28, 2000. (JA 1040-1045.) It is a final judgment that resolves all issues, and it is therefore appealable. (Code Civ. Proc., § 904.1, subd. (a)(1).) Vallely filed a timely Notice of Appeal on March 21, 2000. (JA 1046-1049.)

BACC filed a timely Notice of Cross-Appeal on April 10, 2000 (JA 1053-1055), which states that it seeks review of:

> "(1) the trial court's October 22, 1999, ruling on plaintiff Vallely Investment, L.P.'s ("Vallely") evidentiary objections to the declaration of David Granoff; (2) the trial court's October 22, 1999, ruling on Vallely's evidentiary objections to the declaration of Eric Forsberg; and (3) the trial court's April 6, 1999, order reversing its prior decision to grant BACC's motion for summary judgment based upon the effect of rejection under 11 U.S.C. § 365."

Vallely is concurrently filing a motion to dismiss the cross-appeal on the ground that BACC has no standing because it was not aggrieved by the judgment. However, as explained below, Vallely's own appeal addresses the issues BACC has raised.

STATEMENT OF ISSUES

In its complaint, Vallely requested a declaration that BACC is liable on its written agreement to fulfill the Lease covenants. That was the basis of Vallely's summary judgment motion, and BACC has never denied executing the Assignment. Instead, in its own motions and in opposition to Vallely's motion, BACC urged seven grounds for releasing it from its agreement. The trial court reached only one ground, ruling that RECMC's foreclosure terminated BACC's obligations under the Assignment. In Section I below, we demonstrate why the trial court should have rejected this argument.

The trial court did not reach BACC's six other arguments, finding them moot. However, because this Court can affirm the judgment if it is correct on any theory BACC urged below (*Deschene v. Pinole Point Steel Co.* (1999) 76 Cal.App.4th 33, 39), in Section II we address the following questions:

(a) Does the language of the Assignment somehow limit BACC's liability to the term of its possession?

(b) When BACC lost possession, did it become a surety whose obligations were exonerated when Vallely entered into the Edgewater Addendum without BACC's consent?

(c) When Edgewater purchased the Lease from RECMC, did that transaction constitute a novation that released BACC?

(d) Did Edgewater's rejection of the Lease in bankruptcy extinguish BACC's Lease obligations?

(e) Do the Lease protections that limit a lender's liability apply to BACC?

(f) Was BACC's assumption of the Lease ultra vires under federal banking law?

STANDARD OF REVIEW

Ordinarily a reviewing court considers de novo whether the summary judgment papers reveal a "triable issue as to any material fact" (Code Civ. Proc., § 437c, subd. (c)), undertaking the same analysis as the trial court. (*Aetna Health Plans of Cal., Inc.* v. *Yucaipa-Calimesa Joint Unified School Dist.* (1999) 72 Cal.App.4th 1175, 1186-1187.) Here, however, neither side has suggested any dispute about any of the admitted, material evidence; the parties' arguments in the trial court focused mainly on legal questions. This Court considers de novo the legal effect of undisputed facts. (*Id.* at p. 1186 ["'This court exercises its independent judgment as to the legal effect of the undisputed facts disclosed by the parties' papers.'"].)

BACC has indicated in its cross-appeal notice that it will challenge the trial court's ruling to exclude the Granoff and Forsberg declarations. (JA 1054.) A trial court's exclusion of evidence is affirmed if correct on any ground, whether or not urged by counsel or relied on by the trial court. (*Taggart v. Super Seer Corp.* (1995) 33 Cal.App.4th 1697, 1708; 9 Witkin, Cal. Procedure (4th ed. 1996) Appeal, § 341, p. 383.)

ARGUMENT

I.

IN THE WRITTEN ASSIGNMENT, BACC AGREED TO FULFILL THE LEASE COVENANTS, AND THAT COMMITMENT BINDS BACC EVEN AFTER LOSING POSSESSION AT THE TRUSTEE'S SALE.

The judgment is wrong because it is based on the trial court's mistaken understanding of the unique, hybrid nature of leases. As explained below, leases have aspects of both property conveyances and contracts. Because the trial court completely ignored the latter, it failed to recognize that BACC remains bound by its unqualified contractual agreement to fulfill the Lease covenants.

A. BACC Expressly Assumed The Lease Covenants.

1. A party who expressly assumes a lease's obligations comes into privity of contract with the landlord.

A lease is both a conveyance of a protected possessory interest to the tenant and a contract. (6 Miller & Starr, California Real Estate (2d ed. 1989) § 18:17, pp. 33-36; 4 Witkin, Summary of Cal. Law (9th ed. 1987) Real Property, § 543, p. 712.) This dual character creates two distinct sets of rights and obligations—"those arising by law from the relationship of landlord and tenant (privity of estate), and the contractual obligations arising out of the express stipulations of the lease (privity of contract)." (6 Miller & Starr, *supra*, § 18:17, pp. 34-35.)

An assignment is a sale of the leasehold estate by which the tenant transfers all of its rights of possession to the assignee. (*Id.* at § 18:54, p. 113.) But unless the landlord agrees otherwise, the transfer does not alter the *privity of contract* between the assigning tenant and the landlord. (*Ibid.*) The assignor remains liable even though, having transferred its

entire interest, it cannot enforce the lease against the landlord. (*Id.* at p. 113.) In practice, this means the assignor "remains liable for the payment of rent or taxes if they are not paid by the assignee." (*Id.* at pp. 113-114.)

As for the assignee, the assignment places it in privity of estate with the landlord, and it is liable for the lease covenants for as long as it remains in possession. (*Id.* at § 18:55, pp. 115-116.) But when the assignee takes the additional step of agreeing to perform the lease terms, conditions and limitations, "we have not a naked assignment creating privity of estate only, ceasing with cessation of possession, but one clothed with the express assumption by the assignee of the obligations of the lessee." (*Bank of America etc. Assn. v. Moore* (1937) 18 Cal.App.2d 522, 525.)

In other words, by assuming the lease, the assignee steps into the shoes of the original tenant and comes into both privity of estate and privity of contract with the landlord. (*Ibid.* [assignee bound by privity of contract where he signed assignment clause stating he "hereby accepts, assumes and agrees to perform all of the terms" of the lease]; see generally 6 Miller & Starr, *supra*, § 18:55, p. 117.)

Having agreed to fulfill the lease covenants, the assignee who assumes the lease—like the original tenant—may be held to its bargain for the life of the lease covenants, even if it gives up possession before the end of the lease term. (6 Miller & Starr, *supra*, § 18:55, p. 117 [assignee who assumes lease obligations in writing "is liable for all the lease obligations for the remainder of the lease terms whether they run with the land or not, and regardless whether he has relinquished possession of the premises"].)

The landlord has the right to enforce the assignee's promise to fulfill the lease covenants as a third-party beneficiary of the assignment. (*Ibid.*)

2. BACC expressly assumed the Lease and is therefore bound under its covenants through privity of estate and contract.

Here Balboa, as the original lessee, was both in privity of contract and privity of estate with Vallely. When Balboa assigned the Lease to BACC, BACC came into privity of estate with Vallely. When BACC took the additional step of "covenant[ing] and agree[ing] to and with Assignor, to faithfully observe, perform and fulfill all of the terms, covenants and conditions and obligations required to be observed, performed and fulfilled by Assignor, as lessee under the Ground Lease" (JA 114), it came into privity of contract with Vallely. At that point, BACC fully stepped into Balboa's shoes, becoming liable under the Lease as if it were the original lessee. (JA 12 [Article 1(k)(1): "Lessee" includes those who take by assignment "as if such assignee or transferee had been named herein" as a party to the Lease], 90 [Article 26.1: Lessees who take by assignment are bound "the same as if they were in every case specifically named" as parties to the Lease].)

As the third party beneficiary of the Assignment, Vallely may enforce the Lease against BACC, including the covenants to pay taxes, rent, or damages upon the Lease's breach. (JA 16-32, 82-86 [Articles 3, 4, 22].)

B. The Foreclosure Sale Did Not Disturb BACC's Privity Of Contract With Vallely.

BACC persuaded the trial court that RECMC's foreclosure had the sweeping effect of nullifying everything that occurred after the Balboa Landing-RECMC trust deed was recorded, including all obligations arising under the Assignment. At first blush, this sounds like a correct application of a rule that every lawyer learns in his or her first-year real property class. But it isn't. It fails to recognize another first-year real property principle—the distinction between privity of estate and privity of contract.

RECMC's foreclosure extinguished BACC's *property* interest, just as any foreclosure terminates the debtor's property interest. But the Assignment also created an independent *contractual* relationship between BACC and Vallely that had nothing to do with RECMC. Foreclosure could not extinguish the BACC-Vallely relationship—just as foreclosure on a senior lien, while extinguishing a junior lien, leaves untouched the debt secured by the junior lien. That obligation "is an independent undertaking by the debtor to pay." (*Roseleaf Corp. v. Chierighino* (1963) 59 Cal.2d 35, 38-39 [junior lienor whose security is lost through a senior lienor's foreclosure sale can sue the debtor directly].)

1. The limited purpose of foreclosure is to secure to the lender the title its debtor held when the trust deed was recorded. Foreclosure need not, and does not, affect unrelated contractual relationships.

Title-priority rules operate in a limited sphere. When RECMC purchased the Lease at the trustee's sale, it took the Lease free and clear of any right, title or interest of Balboa and its successor, BACC. (4 Miller & Starr, *supra*, § 9:152, p. 502.) RECMC thus got the title it bargained for in the trust deed. But that is as far as the title analysis reaches. It provides no basis for extinguishing BACC's Lease liability *to Vallely*, because (a) BACC's status as a primary obligor does not depend on its remaining in possession and (b) RECMC acquired clear title regardless of whether BACC continued to remain liable to Vallely.

As this Court has observed, the policy served by allowing a foreclosure purchaser to acquire leasehold title free of post-mortgage encumbrances is "to protect lending institutions from fraudulent amendments to leases which would encumber the value of their acquired property." (*R-Ranch Market #2, Inc. v. Old Stone Bank* (1993) 16 Cal.App.4th 1323, 1328.) Here, that protection was fully accomplished by stripping BACC of its possessory interest. BACC's contractual

obligations to Vallely, however, did not constitute any kind of encumbrance that RECMC needed any protection against.

2. A foreclosure sale is simply a forced assignment of the lease, leaving the assignor liable to the lessor as with any other assignment.

When Balboa defaulted on its loan, RECMC, as the lender and beneficiary, had the right to enforce its trust deed by having the leasehold estate sold at a trustee's sale. (4 Miller & Starr, *supra*, § 9:93, p. 307.) There, RECMC was free to bid for the Lease along with any other prospective purchaser. (*Alliance Mortgage Co. v. Rothwell* (1995) 10 Cal.4th 1226, 1238.) When its bid was successful, RECMC became—as any successful bidder would become—"an assignee of the lease and liable thereby through privity of estate for all tenant obligations accruing during his ownership of the lease." (1 Friedman on Leases (3d ed. 1990) § 7:802, p. 426; *Baker v. Maier & Zobelein Brewery* (1903) 140 Cal. 530, 534 [defendant who took possession upon foreclosure of chattel mortgage was assignee by operation of law].) Hence BACC remained liable under the Lease covenants just as any other assignor would be, and Vallely retained its right to enforce the Lease covenants against BACC, just as any other lessor would against a former lessee: "Even though the assignment is by operation of law and the estate is taken from the lessee against his or her consent, the lessee continues liable upon the express covenants." (49 Am.Jur.2d (1995) Landlord and Tenant, § 1120, p. 878.)

3. BACC's main authority—and the only case the trial court cited—involves the inapposite situation of a lease that was subordinate to a trust deed.

The preceding discussion demonstrates why BACC's sole authority in the trial court, *Dover Mobile Estates v. Fiber Form Products, Inc., supra,* 220 Cal.App.3d 1494, does not apply.

In *Dover*, Fiber Form leased property from Old Town Properties. The lease provided that it would be subordinate to any trust deeds placed on the property. Old Town took out a loan secured by a trust deed on the property. The lender later foreclosed, and Dover bought the property. Fiber Form subsequently vacated the premises and refused to pay further rent, maintaining that the foreclosure extinguished the lease. The Court of Appeal agreed, recognizing that the lease was subordinated to the trust deed by operation of the lease provisions, and that, consequently, the outcome was governed by the general rule that "[a] lease which is subordinate to the deed of trust is extinguished by the foreclosure sale." (*Id.* at p. 1498.) As a result, Dover took the property free of the lease. (*Ibid.*)

Dover's facts are not Vallely's. Here, the Lease is the *subject of* the trust deed; it was never *subordinate to* the trust deed.[1] (JA 47, 65-66 [Articles 8.1, 12.2].) Unlike the *Dover* lender, a lender whose trust deed encumbers a lease can never extinguish the lease itself. The best the lender can aspire to is to become the current lessee by purchasing the leasehold estate at the foreclosure sale. (Halper, Ground Leases and Land Acquisition Contracts (1999) § 2.01[3], p. 2-8.13.) In that case, the lender steps smoothly into the lessee's shoes, the lease continues in effect, and there is nothing to sever the privity of contract between the lessor and former lessee.

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[1] But even in a subordinated lease context, *Dover* is not the last word. Two later cases clarify that the parties to a lease can override the effect of foreclosure by express agreement. Thus in *Principal Mutual Life Ins. Co. v. Vars, Pave, McCord & Freedman* (1998) 65 Cal.App.4th 1469, 1485-1488, foreclosure did not extinguish the lessees' covenant to attorn to the new lessor, who could enforce their promise as a third-party beneficiary. Similarly, in *Miscione v. Barton Development Co.* (1997) 52 Cal.App.4th 1320, 1332 the court recognized that the parties could validly contract that a lease would not be extinguished by foreclosure, and the tenants would attorn to the new lessor. Both cases illustrate how contractual lease obligations can survive foreclosure.

4. Privity of contract binds BACC to its Lease obligations even after dispossession by foreclosure.

Privity of contract is the glue that binds BACC to Vallely for the life of the Lease covenants. Although this general principle, which undercuts the trial court's ruling, is clear, we have not found a California decision that applies it in a case like this one. However, *P.S.G. Limited Partnership v. August Income/Growth Fund VII* (1993) 115 N.M. 579 [855 P.2d 1043] presents a thorough privity discussion in a lease and foreclosure context.

In *P.S.G.*, a lessee, HDC, mortgaged its leasehold interest. The lessor agreed to subordinate its fee interest but expressly excepted its rights to ground lease payments. (*Id.* at p. 1044.) The lessor assigned its interest to PSG. HDC, in a complicated transaction, itself became one of a number of sublessees, the sublessor being South-West Commercial Leasing. (*Id.* at pp. 1044-1045.) The sublease provided for liquidated damages in the event the sublessees defaulted on their rent. (*Id.* at p. 1045.) After a while, the sublessees could neither pay the mortgage nor the rent. That caused South-West to default on the lease, and the lender initiated foreclosure proceedings. (*Ibid.*) During the foreclosure action, PSG terminated South-West's leasehold interest, thereby succeeding to South-West's rights and coming into privity of contract with the sublessees. (*Ibid.*) PSG then sought to enforce the sublease's liquidated damages provisions. The sublessees, resisted on the basis that the foreclosure sale terminated the lease and their sublease, relying on *Dover Mobile Estates*. The court disagreed:

> "If PSG's claims were based only on its property rights flowing from privity of estate under the sublease, [the sublessees'] arguments regarding extinguishment would be dispositive because the foreclosure action destroyed all *possessory* claims that were junior to the senior lien." (*Id.* at p. 1046, emphasis added.)

The court recognized, however, that PSG's claims were all based upon its *contract* rights, "and none of these rights were destroyed by the property foreclosure action." (*Id.* at p. 1048.) In brief, "[a] foreclosure action is one in which property rights concerning land are determined," but the action does not, and cannot, affect contract rights designed to furnish security to the lessor arising out of a tenant's breach. (*Ibid.*)

Here, the Assignment is analogous to *P.S.G.*'s sublease. Like the *P.S.G.* sublessees, BACC lost its right to possess the property upon RECMC's foreclosure. But foreclosure could not terminate BACC's independent promise to fulfill the Lease covenants, just as foreclosure could not terminate the *P.S.G.* sublessees' liability under their liquidated damages provision. BACC's promise provides security to Vallely in the event of a later tenant's default, and Vallely has the right to sue to enforce it. (1 Witkin, Summary of Cal. Law, *supra*, Contracts, § 663, p. 602 ["When a tenant assigns a *lease*, and the assignee agrees 'to perform all of the terms' thereof, the agreement between the tenant and assignee is for the benefit of the *lessor*, and he may sue the assignee," emphasis in original].)

In sum, the resolution of this appeal boils down to first-year law school principles, but they come from the contracts class as well as the property class. BACC expressly agreed to be liable under the Lease. An act beyond its control (RECMC's foreclosure) took away some of the benefit BACC had under its bargain (i.e., possession). But that fortuity doesn't release BACC from the Lease's burden. BACC remains liable to Vallely for performance of the Lease covenants.

II.

NONE OF BACC'S OTHER ARGUMENTS PROVIDES A BASIS FOR AFFIRMANCE.

Though BACC prevailed on its foreclosure argument, BACC also urged six other grounds that the trial court did not reach. Since this court can affirm on any ground urged in the trial court, we assume BACC will urge them again here. None has merit.

A. There Is No Basis In The Lease Or Assignment Language For An Interpretation That Limits BACC's Liability To The Term Of Its Possession.

In opposing Vallely's summary judgment motion, BACC argued that it did not intend to assume more than "an extremely limited interest" in the Lease, expecting its interest to terminate upon conclusion of RECMC's foreclosure. (JA 594.) But the Lease and Assignment terms negate BACC's argument, and BACC's only other support was inadmissible and irrelevant.

1. The Lease language unambiguously binds lessees and does not provide for their later release under any circumstances.

Parties to ground leases sometimes bargain for exculpation clauses limiting their liability to events occurring while in possession and relieving them of any further liability upon their disposing of their interest. (Halper, Ground Leases and Land Acquisition Contracts, *supra*, § 2.07[8], pp. 2-78–2-80.)

Here, the Lease contains exculpation clauses for lenders and for the lessor.[2] Noticeably absent is any exculpation clause for lessees. Instead,

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[2] The lender's exculpation clause provides: "No Leasehold Mortgagee under any Leasehold Mortgage or holder of indebtedness secured thereby or purchaser at foreclosure sale shall incur or be required to assume liability for the payment of rental under this lease or for the performance of any of Lessee's covenants and agreements contained herein, unless and until such leasehold Mortgagee or holder of indebtedness shall have become the owner of the leasehold estate hereunder by foreclosure or by assignment in lieu of foreclosure, *whereupon the liability of any such person shall be only such as may arise by operation of law by reason of privity of estate*." (JA 70 [Article 13(e), emphasis added].)

The lessor's exculpation clause provides: "[I]n the event of any transfer or transfers of the title to such fee, Lessor . . . shall be

the Lease requires all lessees who take by assignment to unconditionally assume the Lease.[3] Lessees who take by assignment become parties to the Lease "as if they were in every case specifically named." (JA 90 [Article 26.1].) These provisions reflect a sensible trade-off: In exchange for allowing free assignability (see JA 65), the lessor receives from the original lessee and each assignee-lessee a payment obligation that they cannot shed by simply assigning their interest.

2. The Assignment's terms unambiguously and unqualifiedly bind BACC to the Lease.

BACC argued in the trial court that although the document is entitled "Assignment," it is really a sublease agreement. (JA 824-826.) But, as we show below, the evidence negates this argument. BACC also argued that because the Assignment was made "expressly subject to the lien" of the trust deed (JA 114), BACC's liability was contractually limited to the term of its possession. (JA 594-595.) But, we show below, that is not what "subject to" means in the context of property conveyances.

It is unreasonable to infer that BACC, a subsidiary of one of the largest banks in the world (JA 699, 910), did not understand the special meaning and legal consequences of the terms "assignment" and "subject to" in real estate instruments. (See *Swarzwald v. Cooley* (1940) 39 Cal.App.2d 306, 321 [remarking that it would be unreasonable to believe that "officers

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automatically freed and relieved, from and after the date of such transfer or conveyance, of all personal liability as respects the performance of any covenants or obligations on the part of the Lessor contained in this lease thereafter to be performed[.]" (JA 91 [Article 26.2].)

[3] In the recorded assignment, "the assignee shall expressly accept and assume all of the terms and covenants in this lease contained, to be kept, observed and performed by Lessee[.]" (JA 66 [Article 12.2].) Any assignment is "void and ineffective" to the extent the lessee attempts to convey anything less than "a complete assignment, transfer, mortgage or encumbrance, as the case may be, of Lessee's interest in this lease[.]" (JA 76 [Article 18.1].)

of a great bank" could have interpreted a contract term according to its provincial—rather than its well-established legal—use]; *Weinreich Estate Co. v. A.J. Johnston Co.* (1915) 28 Cal.App. 144, 147, 149 [where language had acquired a "'legal meaning' at variance with its literal import" as established in case law, it would be "unreasonable" to construe language contrarily].)

a. An assignment is a conveyance of a tenant's entire interest, which is what Balboa conveyed to BACC.

"Assignment" is a property term with a universally recognized meaning: It is the transfer by a tenant of its entire interest for the full unexpired term of the original lease, without reservation of a reversionary interest. (6 Miller & Starr, *supra*, § 18:52, p. 109.) That is exactly what Balboa granted BACC. There is no provision in the Assignment for a reversion. In fact, the Assumption Stipulation confirms that Balboa sold the Lease to BACC outright. (JA 396-398.) Regardless of what a conveyance instrument is called, when, as here, it transfers to the assignee precisely the same estate the assignor held, it is an assignment, not a sublease. (6 Miller & Starr, *supra*, § 18:52, p. 110.)

b. The "subject to" language only limited BACC's liability on Balboa's debt to RECMC; it had no effect on BACC's Lease obligations to Vallely.

The Assignment provides that it is made "subject to" RECMC's deed of trust. (JA 114.) In the trial court, BACC argued that this clause was included so that the Assignment "would remain effective only for as long as it took RECMC to foreclose." (JA 595.) This interpretation ignores the well-known meaning of a "subject to" conveyance.

A grantee of mortgaged property need not assume the underlying debt. (4 Miller & Starr, *supra*, §§ 9:33-9:34, pp. 92-97.) The standard way to confirm that the grantee does not agree to be personally liable for the obligation secured by the loan or for any deficiency after foreclosure is to say that the grantee takes "subject to" the lien. (*Ibid.*) In other words, "subject to" is a term of art:

> "The phrase 'subject to' goes beyond its obvious meaning that the land in the hands of the transferee can be reached by the mortgagee upon default; this is always true regardless of any assumption agreement by the parties. It also means that as between the transferor and transferee, the debt is to be satisfied out of the land." (Nelson & Whitman, Real Estate Finance Law (3d ed. 1993) § 5.3, pp. 297-298; see also 12 Thompson on Property (1994) § 101.05(a)(5), p. 438 ["it is common to limit the phrase 'subject to the mortgage' to transfers of mortgaged property in which the transferee does not assume the mortgage debt"].)

By taking the Lease "subject to" the trust deed, BACC confirmed that it was *not* assuming Balboa's debt to RECMC. What BACC *did* do was to unequivocally assume the Lease and its covenants. The practice and effect of assuming a lease but declining to assume collateral debts or duties where the focus of *County of Albany v. Albany County Industrial Development Agency* (N.Y.App.Div. 1996) 218 A.D.2d 435 [638 N.Y.S.2d 973]. There, the plaintiff leased its premises to a company that mortgaged its interest, then defaulted. The mortgagee acquired the leasehold in a foreclosure action then assigned it to Exchange Street Associates. At that time, there were liens for unpaid water, sewer and fire charges imposed by the town. A provision of the assignment made it "subject to . . . all taxes, assessments, water and sewer rents which are a lien upon the premises." (638 N.Y.S.2d at p. 975.) In deciding that Exchange Street Associates was not personally liable for these charges, the court reiterated the "well-settled rule" "that one who accepts a conveyance 'subject' to a lien or claim does

not assume by such acceptance the obligation to discharge the lien or satisfy the claim." (*Ibid.*) In contrast to the "subject to" provision, the assignment expressly provided that Exchange Street Associates "agrees to assume" the terms and conditions of the lease-purchase agreement.

> "By using both the terms 'subject to' and 'assume' in the assignment, the parties to the assignment clearly acknowledged the different legal significance of those terms with regard to the assignee's personal liability. [Citation.] It is clear, therefore, that, as a matter of law, the assignment imposed no personal liability on [Exchange Street Associates] for the water, sewer and fire charges at issue in this action." (*Ibid.*)

In short, the Assignment's "subject to" language has nothing to do with the Lease obligations BACC expressly assumed. It certainly imposes no limitation on their scope or duration.

3. The trial court properly excluded BACC's inadmissable extrinsic evidence.

BACC offered two declarations to support its revisionist interpretation of the Lease language: (1) *David Granoff*, an attorney at a law firm retained by RECMC and BACC to handle their interests during Balboa's bankruptcy (JA 696, 703, 796), and (2) *Eric Forsberg*, a Bank of America vice president (JA 909). Attached to Forsberg's declarations are two memos bearing an RECMC logo that describe the assignment from Balboa to BACC and RECMC's subsequent taking of the leasehold estate. (JA 912-913.)

Vallely objected to both declarations on the grounds of abuse of discovery, lack of foundation, hearsay, and impermissible opinion. (JA 777-779, 807-809, 924-925.) The trial court excluded the evidence as moot, since the court did not reach any of the issues to which the evidence pertained. (RT 70-72.) Its ruling must be affirmed if correct under any

theory, whether or not raised below. (*Taggart v. Super Seer Corp., supra,* 33 Cal.App.4th at p. 1708 [with respect to evidentiary rulings excluding evidence, "[w]e review only the trial court's ruling, not its reasoning"].) The ruling was correct because the declarations are rife with incompetent, irrelevant, hearsay statements and inadmissible legal opinion.

Incompetency (Evid. Code, § 702, subd. (a)): Neither Granoff nor Forsberg show they have personal knowledge. Granoff does not explain in what capacity he was involved in the foreclosure negotiations or if he ever even talked to BACC's officers. And Forsberg doesn't even claim he was involved in the foreclosure proceedings at all; his knowledge appears to be derived from reviewing documents in the course of working on this litigation. (JA 909; *Taggart v. Super Seer Corp.*, *supra*, 33 Cal.App.4th at p. 1706, fn. 6 [witness who had no personal knowledge of how company's testing was conducted, or how reports were prepared, but whose testimony was based on the contents of the reports themselves was incompetent].) Their declarations, therefore, were properly excluded. (Code Civ. Proc., § 437c, subd. (d) [declarations submitted in support of an opposition to summary judgment "shall show affirmatively that the affiant is competent to testify to the matters stated in the affidavits or declarations"].)

Hearsay (Evid. Code, § 1200): Granoff's declaration is hearsay because it simply reflects what he heard RECMC or BACC's officers say, or what he heard from others about their intentions. (Evid. Code, § 1200.) The two memos attached to Forsberg's declaration are also hearsay. To avoid this objection, BACC appears to offer them as business records. (Evid. Code, § 1271.) However, even business records must have a legally sufficient foundation. (*Remington Investments, Inc. v. Hamedani* (1997) 55 Cal.App.4th 1033, 1036.) Forsberg fails to describe the Bank's recordkeeping practices, and he fails to present any information about the positions or authority of the individuals who prepared and received the memos, or their sources; hence, his statements about the memos' preparation and accuracy are not entitled to any weight, and the memos were properly excluded. (*Ibid.*; see also *Taggart v. Super Seer Corp.*, *supra*, 33 Cal.App.4th at p. 1706 [where custodian's declaration contained

no evidence as to what the reports were, how they were prepared, or what sources of information they were based on, the reports failed to qualify for admission as business records].)

Irrelevancy (Evid. Code, § 210): The memos attached to Forsberg's declaration are irrelevant not only because they say nothing about the key point—which is not how long BACC was to hold the property, but rather whether BACC would remain liable afterwards—but also because they post-date the Assumption Stipulation and the Assignment. At the very most, they are an after-the-fact description of RECMC's subjective intent, with no evidence that either RECMC or BACC expressed any such intent at the time the contracts were formed. Evidence of subjective, unexpressed intent is irrelevant to the interpretation of a contract. (See *Shaw v. Regents of University of California* (1997) 58 Cal.App.4th 44, 55 ["The true intent of a contracting party is irrelevant if it remains unexpressed."].)

Impermissible Legal Opinion (Evid. Code, § 801): Granoff's conclusions about the foreclosure's effect on BACC's continuing obligations to Vallely are inadmissible legal opinions. (*Summers v. A.L. Gilbert Co.* (1999) 69 Cal.App.4th 1155, 1178 ["There are limits to expert testimony, not the least of which is the prohibition against admission of an expert's opinion on a question of law."].)

Even if the declarations were admitted, they make no difference. BACC may well have entered into the transaction to facilitate the Balboa foreclosure; that much can be inferred from the Assumption Stipulation. But while Vallely disputes that BACC signed the Assignment oblivious to the long-term liability consequences—why, besides knowledge of that risk, would BACC and RECMC hide BACC's involvement from Vallely?—it doesn't really matter. Regardless of what BACC thought about how long it would hold the Lease, or for what purpose, or the scope of its liability, its intentions cannot alter the legal effect of its express, unqualified assumption of the Lease. (*Berman v. Bromberg* (1997) 56 Cal.App.4th 936, 947 [plaintiff's intent upon cashing a check was "'immaterial to whether such a

sale in fact occurred, and "in no way changed the fundamental character of that transaction""]; *South Lakeview Plaza v. Citizens National Bank of Greater St. Louis* (Mo.Ct.App. 1985) 703 S.W.2d 84, 86 [bank-assignee that expressly assumed lease was liable to lessor for rent, whether or not the parties intended assignment to be merely a mortgage]; *Iorio v. Superior Sound, Inc.* (N.Y.App.Div. 1975) 49 A.D.2d 1008, 1008 [374 N.Y.S.2d 76, 77] ["The acknowledgment that the parties intended assignment to a corporation to be newly formed does not militate against the clear terms of this lease or contradict the intention to maintain primary liability for the rent with defendant."].)

B. BACC Is Not A Surety, But Even If It Were, It Was Not Exonerated By A Trivial Modification Of The Lease Between Vallely and Edgewater.

BACC argued that after RECMC assigned the Lease to Edgewater, BACC became, "at most," a surety under the Lease. (JA 340.) It claimed exoneration under Civil Code section 2819 because, it argued, the Edgewater Addendum materially modified the Lease. (JA 340-345.)[4] BACC is wrong because:

(1) Surety defenses are not available to assignor-lessees under settled California real property law;

(2) Even if the surety defense of exoneration were available to assignor-lessees, it would not be available to BACC, because (a) Vallely had no notice of BACC's surety status until after it entered into the Edgewater Addendum, and (b) the Addendum's modification of Edgewater's rent obligation was too trivial to trigger an exoneration.

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[4] Section 2819 states in relevant part: "A surety is exonerated, except so far as he or she may be indemnified by the principal, if by any act of the creditor, without the consent of the surety the original obligation of the principal is altered in any respect, or the remedies or rights of the creditor against the principal, in respect thereto, in any way impaired or suspended."

1. An assigning tenant is not a surety; at all times, it remains primarily liable for performance of the lease's covenants.

The landlord/tenant/assignee relationship is like no other in contract or property law. *DeHart v. Allen* (1945) 26 Cal.2d 829, 832 provides the controlling statement of the applicable principles:

> "Ordinarily an assignment of a lease does not release the lessee from his obligations even though the lessor consents to the assignment. [Citation.] Nor does the express assumption by the assignee of obligations under the lease affect the liability of the lessee to the lessor. [Citations.] It has sometimes been said that the effect of an assignment is to make the lessee a surety for the assignee. [Citations.] This may be true in a limited sense as between the assignee and his assignor, the lessee, *but as between the lessor and the lessee the latter remains a primary obligor under his express contract to pay rent.*" (Emphasis added.)

The *DeHart* rule was reaffirmed in *Peiser v. Mettler* (1958) 50 Cal.2d 594, 602 and in *Meredith v. Dardarian* (1978) 83 Cal.App.3d 248, 252.

Meredith is squarely on point. There, the original lessees assigned the lease to a lessee who stopped paying rent. The landlord filed an unlawful detainer action in which it also sought past due rent from the original lessees. They objected that they were sureties who had been discharged "through unauthorized extensions of time [and] failure of the landlord to act for eviction for over a year" and because the lessor "consented to a substantial alteration of the premises, without the consent of appellants." (*Id.* at p. 251.) The Court of Appeal, quoting *DeHart*, held that the original tenants were *not* sureties, and accordingly were "not entitled to the defense of exoneration of a surety." (*Id.* at p. 252.) "Such being the case, even if 'unauthorized extensions of time' were given or

modifications to the premises which could not be restored had occurred, such facts would not constitute a defense." (*Ibid.*)

As *Meredith* makes clear, California law allows no room for surety defenses in the law of lease assignments. (4 Witkin, Summary of Cal. Law, *supra*, Real Property, § 635, p. 822 ["it seems that [the original lessee] is not a true surety with the right to set up suretyship defenses"]; Friedman, Garcia & Hagarty, Cal. Practice Guide: Landlord-Tenant (The Rutter Group 1999) § 2:382.1, p. 2B-96 ["unlike the situation of a guarantor and principal obligor, a subsequent modification of the lease will *not* completely exonerate the assignor"]; 6 Miller & Starr, *supra*, § 18:54, p. 114 ["The assignor is not exonerated, and remains liable on the lease even though the landlord grants unauthorized extensions of time to the assignee, or permits the assignee to alter the premises."].)

In its summary judgment papers, BACC relied on two post-*Meredith* decisions that make sweeping statements to the effect that an assigning lessee is a surety. (JA 856, citing *Kendall v. Ernest Pestana, Inc.* (1985) 40 Cal.3d 488; *Superior Motels, Inc. v. Rinn Motor Hotels, Inc.* (1987) 195 Cal.App.3d 1032.) In both cases, however, the only relevant issue was the lessor's right to resort to the assignor-lessee in the event of a later tenant's default, and, as *DeHart* recognizes, in that limited sense the assignor is like a surety. The courts were not asked to address whether the assignor was entitled to raise surety defenses. An appellate decision is only authority "'for the points actually involved and actually decided.'" (*Santisas v. Goodin* (1998) 17 Cal.4th 599, 620.) *DeHart* and *Meredith* therefore remain the controlling authorities.[5]

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[5] BACC submitted the declaration of attorney Dennis Arnold, who gave his legal opinion that BACC was a surety. (JA 448-452.) The court ordered the declaration excluded on mootness grounds. (RT 69-70.) The ruling was correct regardless of mootness, because expert testimony is not permitted on questions of law. (*Summers v. A.L. Gilbert Co.*, *supra*, 69 Cal.App.4th at p. 1178.)

2. In any event, BACC cannot invoke surety defenses because Vallely had no notice of BACC's purported surety status.

Even a conventional surety cannot rely on surety defenses unless the creditor has notice of the surety's status. Since Vallely had no notice of BACC's purported surety status until after it executed the Edgewater Addendum, BACC cannot now claim surety defenses.

Harrier v. Bassford (1904) 145 Cal. 529, 532-533 illustrates. After entry of a deficiency judgment against defendants J.M. and Ida Bassord following a foreclosure, J.M. was released on paying $400. Ida argued that she was actually a surety, that J.M. Bassford was the principal, and that J.M.'s release "operate[d] to release the judgment as against the sureties also." (*Id.* at pp. 532-533.) The court rejected this argument because Ida did "not show that the obligee had any notice whatever of the alleged fact that J.M. Bassford, senior, was the principal and Ida C. Bassford a surety on the note upon which the judgment is founded." (*Id.* at p. 533.) The rule that release of the principal releases the surety "cannot be applied in cases where it is not shown that the obligee, at the time of the release, was aware of the relations between the debtors." (*Ibid.*)

Other cases are in accord. For instance, in *Mead v. Sanwa Bank California* (1998) 61 Cal.App.4th 561, 571, the court observed that "if an apparent principal alleges both that his or her relationship with a co-obligor is one of surety and principal *and that the creditor knows of that agreement between the two obligors*, he or she has alleged sufficient facts to support the allegation that he or she is bound to the creditor as a surety only." (Emphasis added; see also *Westinghouse Credit Corp. v. Wolfer* (1970) 10 Cal.App.3d 63, 68 ["*[a]s soon as Westinghouse learned* of the assumption by Savoy of appellant's debt to Westinghouse, Westinghouse was required to recognize the relation of suretyship between Savoy and appellant and respect it in all of its subsequent dealings with them," emphasis added]; *Everts v. Matteson* (1942) 21 Cal.2d 437, 447-448 ["Although the creditor may treat both the grantor and grantee as debtors,

yet, *after receiving knowledge of the assumption*, he must recognize the relation of suretyship and respect the rights of the surety in all of his subsequent dealings with them," emphasis added.)

Here, the Lease allows a lessee to freely assign the Lease but requires the parties to the assignment to provide the lessor with notice. (JA 65-66 [Article 12.2].) When BACC assumed the Lease, it did not notify Vallely. (JA 590-591, 725, 789.) Since the Lease required notice and since BACC is a self-described "sophisticated business entit[y]" (JA 590), the omission was undoubtedly deliberate. But whatever the reason was, Vallely never had the opportunity to seek BACC's consent to the Edgewater Addendum. Both settled suretyship law and basic principles of fairness estop BACC from claiming exoneration.

3. Even if BACC were a surety entitled to surety defenses, at most the Edgewater Addendum exonerated only BACC's 1996 rent obligation.

Below, BACC relied mainly on one case to support its position that the Edgewater Addendum was a material Lease modification that exonerated it as a surety. (JA 343-345.) That case, *V.I.P. Agency of No. Cal., Inc. v. Duffy Electronics* (1979) 92 Cal.App.3d 849, is not on point.

In *V.I.P.*, an insurance company posted a bond on behalf of defendant Duffy. Duffy ultimately admitted liability and stipulated with plaintiff to a one-year payment schedule. When Duffy defaulted, the plaintiff sued the insurance company, which argued exoneration. The Court of Appeal held that "transforming an immediate obligation to pay into an obligation that was enforceable only according to a schedule of deferred payments, was a substantial alteration" that exonerated the insurance company. (*Id.* at p. 852.) That is not the case here. All the Edgewater Addendum did was to divide into monthly payments the lump-sum rent obligation for one year out of the Lease's 66 years. This trivial, temporary accommodation did not alter the overall lease term in any way. (JA 445 ["Except as otherwise expressly provided in this Addendum, all other

agreements and covenants set forth in the Lease shall remain in full force and effect without change."].)

At most, the modification could only exonerate BACC for the 1996 rent. A lease is divisible: Each rent installment is a separate, independent obligation. (*Tsemetzin v. Coast Federal Savings & Loan Assn.* (1997) 57 Cal.App.4th 1334, 1344 ["periodic monthly rental payments called for by a lease agreement create severable contractual obligations"]; 3 Witkin, Cal. Procedure, *supra*, Actions, § 486, p. 612.) A lessor's concessions regarding one rent installment do not affect a guarantor's liability for later installments. (See, e.g., *Glasscock v. Console Drive Joint Venture* (Tex.Ct.App. 1984) 675 S.W.2d 590, 592 [extension of lessee's time to pay past due rents did not release guarantor from liability for remainder of rents]; *Coe v. Cassidy* (1878) 72 N.Y. 133 [1878 WL 12473] [extension of time to pay one rent installment did not discharge guarantor from liability for remaining rents]; see generally 10 Williston on Contracts (3d ed. 1967) § 1222, p. 729.)

C. BACC Was Not Released By A Novation.

In support of both of its summary judgment motions (JA 278-280, 603-605), BACC argued that there was a novation: "[T]he 1994 transaction whereby RECMC transferred the entirety of its interest in the Property to [Edgewater] completely extinguished any obligations BACC may have owed Vallely under the Ground Lease." (JA 604.) But Vallely was not a party to the transaction, and there can be no novation without the creditor's consent. (6 Miller & Starr, *supra*, § 18:54, p. 113.)

BACC's novel theory is based on a misreading of *Wells Fargo Bank v. Bank of America* (1995) 32 Cal.App.4th 424. (JA 604-605.) In *Wells Fargo*, the Court of Appeal held that "to constitute a novation, rather than a mere assignment, in the context of a new debtor, the former debtor must be released of his obligation by consent of the former debtor *as well as the creditor*." (*Id.* at p. 432, emphasis added.) In *Wells Fargo*, the landlord had manifested the requisite intent because the lease explicitly provided that

the lessee "shall be relieved of all liability accruing under this lease from and after the date of any assignment." (*Ibid.*) The Lease has no such provision. Without one, BACC remains liable.

D. Edgewater's Bankruptcy Did Not And Could Not Terminate BACC's Lease Obligations.

In support of its second summary judgment motion and in opposition to Vallely's summary judgment motion, BACC argued that Edgewater's deemed rejection of the Lease in bankruptcy terminated BACC's Lease obligations. (JA 895-899.) The trial court had earlier rejected this same argument in the context of denying BACC's first summary judgment motion. (JA 323-325.) The court did not reach the argument the second time around.

1. Since BACC did not raise Edgewater's bankruptcy as an affirmative defense in its answer, it could not raise the defense for the first time in its summary judgment motion.

BACC did not plead Edgewater's deemed rejection of the Lease as an affirmative defense. It raised the issue for the first time four months later in its summary judgment motion over Vallely's objections. (JA 130-134, 142-148, 171, 173-174.) That was impermissible. (*Lee v. Bank of* America (1994) 27 Cal.App.4th 197, 215-217 [trial court reviewing a summary judgment motion "is under no duty to inquire whether there are causes of action or defenses inherent in the facts but not articulated by the pleading"]; see also *Tsemetzin v. Coast Federal Savings & Loan Assn., supra,* 57 Cal.App.4th at p. 1343 [failure to plead an open book account precludes reliance on theory to defeat the summary judgment motion]; *Dorado v. Knudsen Corp.* (1980) 103 Cal.App.3d 605, 611 [answer contained no allegations raising coverage by the Workers' Compensation Act; "[t]he summary judgment based on that defense was, therefore,

erroneous"]; *Krupp v. Mullen* (1953) 120 Cal.App.2d 53 [reversing summary judgment based upon affidavits showing estoppel when it hadn't been pleaded].)

BACC sought relief from the new-theory restriction by arguing that because the relevant bankruptcy order was filed a month after BACC filed its answer, BACC could not have raised the defense in its pleading. (JA 201.) That isn't the rule. If a defendant discovers that its pleading is inadequate and requires additional factual allegations to support a possible new defense, it must seek the trial court's leave to amend. (*Lee*, *supra*, 27 Cal.App.4th at p. 216 ["it is incumbent on the pleader to make some request to amend so that the pleading *is* adequate"]; *580 Folsom Associates v. Prometheus Development Co.* (1990) 223 Cal.App.3d 1, 18 ["Should the cross-complainant wish to offer a different factual assertion from that alleged in the cross-complaint, it must move to amend the cross-complaint prior to the hearing on the summary adjudication motion."]; *Dorado*, *supra*, 103 Cal.App.3d at p. 611 ["in the absence of some request for amendment there is no occasion to inquire about possible issues not raised by the pleadings"].)

Finally, BACC argued that it did not need to raise Edgewater's bankruptcy as an affirmative defense because it was not a "new matter" under Code of Civil Procedure section 431.30(b)(2). (JA 201-203.) BACC was wrong again. A defense raises a "new matter" if it is in the nature of "yes, the allegations are true, but . . . ." (*FPI Development, Inc. v. Nakashima* (1991) 231 Cal.App.3d 367, 383; see generally *Walsh v. West Valley Mission Community College Dist.* (1998) 66 Cal.App.4th 1532, 1545-1547 [discussion of "new matter" in context of bank's claim against guarantor of debtor's loan; defense based on allegations independent of those needed to deny elements of bank's claim was "new matter"].) BACC's bankruptcy defense impliedly says exactly that: Assuming the allegations in the complaint are true (i.e., that BACC unqualifiedly assumed the Lease obligations), there is nevertheless a later event—Edgewater's rejection of the Lease in bankruptcy—that terminated BACC's liability. That is a classic "new matter."

2. The bankruptcy order deeming the Lease rejected did not terminate BACC's obligations.

In the trial court, the parties differed over whether Edgewater's rejection of the Lease in bankruptcy proceedings terminated the Lease. (Compare JA 230-235 [Vallely argues Lease not terminated] with JA 272-275 [BACC argues Lease terminated].) But that isn't the relevant issue, as Vallely pointed out. (JA 235-238.) BACC's liability under the Lease cannot be diminished or extinguished by Edgewater's actions.

It has long been recognized that an assigning lessee remains liable under the lease covenants, despite a later lessee's bankruptcy. One leading author identified the fraud that could result under any other rule:

> "It may be that the original lessee is perfectly solvent, and he, as is elsewhere stated, remains liable on the covenants of the lease. If the bankruptcy of his assignee is to end the tenancy and so terminate the landlord's right to enforce the covenant for rent or other covenants, one who has bound himself by a covenant in a lease may relieve himself from all liabilities thereon by the simple device of assigning the leasehold to a 'man of straw' and subsequently procuring, directly or indirectly, an adjudication of bankruptcy as regards the latter." (1 Tiffany, Landlord and Tenant (1910) § 12, p. 96.)

The Court of Appeal recently affirmed this principle in *Tsemetzin v. Coast Federal Savings & Loan Assn., supra,* 57 Cal.App.4th 1334. There, Coast Federal, the original tenant under a ground lease, assigned the lease to another savings and loan. Later, the assignee became insolvent and was placed into receivership with the Resolution Trust Corporation, which "repudiated, disaffirmed and terminated" the lease. (*Id.* at p. 1340.) The Court of Appeal held that the RTC's repudiation of the lease affected only the assignee's obligations to the lessor. Coast Federal, in contrast, had agreed to remain primarily liable under the lease covenants. It was therefore bound to anticipate that its assignee, "for whatever reason," might

not perform under the lease and that it would be called upon to respond to its commitment: "It matters little whether that nonperformance by its assignee resulted from breach, *bankruptcy* or a declared insolvency and imposed receivership." (*Id.* at pp. 1345-1346, emphasis added.) Accordingly, the court concluded that RTC's repudiation of the lease "did not impact [the lessor]'s right to pursue Coast Federal for any and all unpaid rentals coming due after January 31, 1993. Coast Federal remains liable on its express contractual commitments." (*Id.* at p. 1347.)

The *Tsemetzin* rule is codified in federal bankruptcy law. The Bankruptcy Code specifically provides that "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." (11 U.S.C. § 524, subd. (e); see, e.g., *Bel-Ken Associates Ltd. Partnership v. Clark* (D.Md. 1988) 83 B.R. 357, 359 ["After all, what good is a guaranteed lease if the guarantor escapes liability when the debtor does?"]; *Exxon Chemical Americas v. Kennedy* (1982) 59 N.C.App. 90 [295 S.E.2d 770] [where guaranty agreement by its express terms created "primary obligation" from guarantor to creditor, principal debtor's discharge in bankruptcy did not terminate guarantor's liability].)

Here, just as in *Tsemetzin*, Edgewater's deemed rejection of the Lease in bankruptcy proceedings could not affect BACC's liability. As a primary obligor, BACC was bound to anticipate that a later lessee, for whatever reason, might default on its rent payments.

3. The current consensus is that a tenant-debtor's rejection of a lease in bankruptcy does not terminate the lease.

Under *Tsemetzin*, the question of whether Edgewater's bankruptcy "terminated" the Lease is academic, because under California law BACC remains liable under its independent promise to perform the Lease covenants. But even if it were necessary to answer the question, the answer would be "no."

The current view in federal bankruptcy law is that when a lease is deemed rejected by a debtor-lessee, "the debtor's right to possession of the premises is extinguished but the leasehold itself is not." (3 Collier on Bankruptcy (15th ed. rev. 1999) ¶ 365.09[3], pp. 365-75; see also 6 Miller & Starr, *supra*, § 18:117, p. 349, fn. 79 ["A rejection and abandonment does not by itself terminate the lease."]; *In re Bergt* (Bankr.D.Alaska 1999) 241 B.R. 17, 25 [comprehensively analyzing the decisions throughout the country and concluding that a "lease is not terminated by the rejection under the emerging view"].) Because the lease survives, so do the rights and duties of nondebtors with lease interests. (3 Collier, *supra*, ¶ 365.09[3], p. 365-75; see also, e.g., *In re Austin Development Co.* (5th Cir. 1994) 19 F.3d 1077, 1083 ["we conclude that a debtor's inaction in timely deciding to assume or reject a lease of nonresidential real property under § 365(d)(4), which leads to a deemed rejection, does not effect a termination of that lease, or, consequently, an implied forfeiture of the rights of third parties to the lease"]; *In re Modern Textile, Inc.* (8th Cir. 1990) 900 F.2d 1184, 1191 ["the lessor's claim for breach survives the Trustee's rejection; thus, the lessor can still look to the person or entity that guaranteed the debtor's lease obligations"]; *In re Locke* (Bankr.C.D.Cal. 1995) 180 B.R. 245 [debtor-lessee's rejection of lease did not terminate lease as to nondebtor cotenant, and thus did not terminate its liability on judgment lien].)

Although BACC cited a raft of cases in the trial court (JA 146-148, 207-219), for a variety of reasons none is controlling, most importantly because they run counter to the overwhelming trend of current authority. Since BACC may well choose not to persist in relying on outdated authority, we will defer further discussion to our reply brief.

We pause only to address *Ilkhchooyi v. Best* (1995) 37 Cal.App.4th 395, because it is a decision by this Court and is the most recent California decision that BACC relied on below. (JA 142-146.) It addresses a sublessee's status after the master lease is terminated—not our facts. The decision contains a sweeping statement that a tenant-debtor's lease rejection terminates the lease as to all parties, citing older cases that no longer state

the current bankruptcy view. (*Ilkhchooyi*, *supra*, 37 Cal.App.4th at p. 404.)[6] In any event, the Court immediately qualified its statement by recognizing that the lessor had the contractual right to "elect to continue the lease following the bankruptcy," but had not done so. (*Ibid.*) Vallely has a similar contractual right to elect to terminate the Lease on a lessee's petitioning for bankruptcy (JA 82-86 [Article 22]), but, unlike the *Ilkhchooyi* lessor, it has elected to continue the Lease in force.

4. Even if the Lease were deemed terminated, BACC would not be entitled to judgment.

Even if, against the weight of authority, this Court decided that the Lease was terminated by Edgewater's deemed rejection in bankruptcy, that would not end this litigation. The Lease's Article 22 gives the lessor the right, upon termination of the Lease, to seek damages either in the amount of the yearly difference in rents received on reletting or lump-sum damages. (JA 85-86.) Because the damages provisions have "a life of their own according to the intent of the original parties to the lease," they would survive termination of the lease in bankruptcy. (*Chumash Hill Properties, Inc. v. Peram* (1995) 39 Cal.App.4th 1226, 1232 [lease's nondisturbance provision survived lessee's rejection of lease in bankruptcy].) Thus, if the Court held the Lease terminated, Vallely would have a breach of contract claim against BACC, making summary judgment for BACC inappropriate. Instead, the Court should reverse and remand to allow Vallely an opportunity to amend its complaint.

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[6] The current view is that "rejection of the lease does not terminate all rights under lease," and thus "leaves it open" to the sublessee "to prove that under nonbankruptcy law it is entitled to retain its interest even if the debtor-lessee breached the lease." (3 Collier on Bankruptcy, *supra*, ¶ 365.09[3][a], p. 365-75.)

E. BACC Was Not Entitled To Lender's Rights Under The Lease.

BACC argued below that it was RECMC's "agent" and was therefore entitled to the protections of the Lease's exculpation clause for lenders. (JA 596-598; see JA 70 [Article 13(e)].) Like its bankruptcy argument, BACC did not raise this defense in its answer, so the Court need not consider it. In any event, it is without merit.

Article 13(e) is a standard exculpation clause providing that if a lender takes over the lease in a foreclosure, the lender's liability will be limited to events occurring while it is the owner of the leasehold estate, and it will be relieved of any further liability to the lessor after conveying it. (See generally Halper, Ground Leases and Land Acquisition Contracts, *supra*, § 2.07[8], pp. 2-80–2-81.)

Here, the leasehold mortgagee is RECMC, not BACC. (JA 361-362.) BACC is a wholly separate entity. (JA 699.) It is not RECMC's agent because it neither pleaded nor attempted to prove any of the three characteristics of an agency:

> "'(1) An agent or apparent agent holds a power to alter the legal relations between the principal and third persons and between the principal and himself; (2) an agent is a fiduciary with respect to matters within the scope of the agency; and (3) a principal has the right to control the conduct of the agent with respect to matters entrusted to him.'" (*Lewis v. Superior Court* (1994) 30 Cal.App.4th 1850, 1868-1869, quoting *Alvarez v. Felker Mfg. Co.* (1964) 230 Cal.App.2d 987, 999.)

To the contrary, the undisputed evidence was that BACC acted for itself. BACC signed the Assignment as "Assignee." (JA 116.) BACC and Balboa are the only parties to the Assignment. After the assignment, BACC sent a letter to Balboa's tenants identifying itself as the new owner. (JA 721.)

Besides, the purported goal of the Assignment was to avoid an assignment to RECMC in lieu of foreclosure, because RECMC feared that

by accepting the Lease directly from Balboa, its title would merge with Balboa's, and the mechanics' liens would not be extinguished. (See, e.g., JA 594, 892-893.) If BACC were merely RECMC's agent, its acceptance of the assignment from Balboa would have been an acceptance on RECMC's behalf. That would have defeated what BACC says was the transaction's entire purpose.

F. Federal Banking Law Does Not Allow BACC To Escape Liability Under The Ground Lease.

BACC argued below that federal banking law prohibits it from retaining any interest in real property for more than five years without explicit authorization from federal bank regulators. (JA 899-900.) In its view, it had no power to accept a long-term assignment of the Lease and to assume long-term Lease obligations, and to the extent it did so, its act was ultra vires. (*Ibid.*)

BACC relies on 12 U.S.C. § 29: "A national banking association may purchase, hold, and convey real estate for" certain enumerated purposes, but no banking association "shall hold the possession of any real estate under mortgage, or the title and possession of any real estate purchased to secure any debts due to it, for a longer period than five years" except as otherwise provided by section 29. BACC claims that section 29 applies to it through 12 C.F.R. § 225.140 (JA 899), which limits to five years the time a nonbanking subsidiary of a bank holding company may hold debt-acquired assets.

1. BACC did not plead that it was subject to either sections 29 or 225.140.

BACC did not raise ultra vires as a defense in its answer, as Vallely pointed out below. (JA 918.) For the reasons discussed in Section D.1. above, BACC could not properly raise ultra vires as an affirmative defense for the first time in its summary judgment papers. (See also *California*

Concrete Co. v. Beverly Hills Savings & Loan Assn. (1989) 215 Cal.App.3d 260, 273 [defendant federal savings and loan association waived its statutory defenses under 12 U.S.C. § 1823(e) (agreements against FDIC's interests in acquired assets) and under federal common law by failing to raise in its pleadings either the statute, or any of the four elements on which it is based, as an affirmative defense; summary judgment in favor of the association reversed]; *Coker & Taylor, Inc. v. R.F. Pruitt* (1932) 124 Cal.App. 439, 443 ["Appellant [national bank] did not plead the defense of *ultra vires* and there is no evidence in the record to support such contention."].)

2. BACC's own evidence established that its assumption of the Lease was a necessary part of a legitimate lending transaction and therefore was not ultra vires.

Even assuming BACC had not waived this defense, there is no section 29 or 225.140 violation. BACC fully divested itself when RECMC acquired the leasehold estate at the trustee's sale. That was all federal banking law required. After that, BACC did not hold any "real estate" or debt-acquired "asset" under sections 29 or 225.140. But the sale did not free BACC from its contractual Lease obligations.

Long ago, it was settled that a bank may enter into a long-term lease—even a lease longer than its charter—without exceeding its section 29 powers. (*Brown v. Schleier* (8th Cir. 1902) 118 Fed. 981, 984 [decided under section 29's predecessor statute].) That is because the lease interest is "salable during the life of the corporation or on its dissolution." (*Ibid.*) But a sale of the lease "does not free the lessee from his obligations thereunder; he remains liable on his covenants, unless the lessor expressly or by implication releases the liability." (*Weeks v. International Trust Co.* (1st Cir. 1903) 125 Fed. 370, 374.) This rule applies to a national bank-lessee that assigns its lease. (*Ibid.*) It applied to BACC after it turned the Lease over to RECMC.

Nor was there anything ultra vires about BACC's entering into the Assignment. BACC is permitted under federal banking law to assume a continuing contractual obligation as part of a legitimate real estate transaction. (*Pinckney v. Wylie* (5th Cir. 1936) 86 F.2d 541, 543 [in satisfaction of a debt, bank obtained mortgaged land and assumed the mortgage, thereby remaining liable even after selling the property]; see also *Frank v. Giesy* (9th Cir. 1941) 117 F.2d 122, 125-126 [in order to effect valid assignment, bank had to agree to remain liable under the lease; agreement not ultra vires]; *Exchange Bank of Commerce v. Meadors* (1947) 199 Okla. 10, 14 [184 P.2d 458, 464] ["If it is within the power of the National Bank to acquire real estate under the Banking Act, the weight of authority is in favor of the view that it may, as a part of the transaction, assume and agree to pay a mortgage thereon."].) The Balboa-RECMC workout required BACC to take over the Lease. The Lease, in turn, required BACC to assume the Lease obligations, or the assignment would be void. (JA 66 [Article 12.2].) BACC's assumption of the Lease obligations, then, was a necessary component of a legitimate lending transaction and not ultra vires.

Below, BACC relied on *Houston v. Drake* (9th Cir. 1938) 97 F.2d 863. (JA 900.) In that case, a bank leased certain premises that it occupied. Later, it assigned the lease to another bank (Consolidated Bank), which assumed the lease and agreed to pay the reserved rent because it considered it "'good business' and because it was thought that a profit could be made by sub-leasing the premises." (*Id.* at p. 865.) Consolidated Bank was liquidated, and the liquidator sought to disaffirm the lease as ultra vires. Since the bank had acquired the lease for speculative purposes, the court held the assignment to be ultra vires. *Houston* does not apply because BACC took over the Lease for the purpose of facilitating RECMC's foreclosure—not for speculation. (12 U.S.C. § 24 [national bank may exercise "all such incidental powers as shall be necessary to carry on the business of banking"]; *National Bank v. Matthews* (1878) 98 U.S. 621, 626 [25 L.Ed. 188] [section 29's object includes deterring banks "from embarking in hazardous real-estate speculations"].)

3. Because Vallely did not release BACC, BACC is liable just as any other assignor would be.

BACC's predicament arises because it opted to assume the Lease behind Vallely's back. It did so at its peril. The Office of the Comptroller of the Currency specifically advises banks seeking to divest themselves of a noncomplying lease under section 29 to "always attempt to seek a release from the landlord" and "[i]n the event such a release cannot be obtained at a reasonable expense," to "document its attempt." (O.C.C. Interpretive Letter No. 491 (Sept. 6, 1989) 1989 WL 534992, *3.[7]) The reason is clear. Without the lessor's release, a bank is liable under a lease assignment agreement just like any other private party. (See, e.g., *South Lakeview Plaza*, *supra*, 703 S.W.2d at p. 86 [bank that expressly assumed leasehold interest was bound by privity of contract to pay rents upon lessee's default].)

The only way for BACC to have avoided liability under the Lease after relinquishing possession was to negotiate a release with Vallely. Instead, BACC kept the whole transaction secret. It presumably made a business decision that the risk of later discovery by Vallely and Vallely's assertion of its rights against BACC was worth whatever short-term gain BACC reaped from the Balboa foreclosure. After all, if RECMC had not had the poor judgment or poor luck to sell the Lease to a tenant that defaulted less than two years later, BACC's liability might never have materialized. It has now.

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[7] Vallely requests the Court take judicial notice of the O.C.C. Interpretive Letter and has attached a copy of that letter to its concurrently filed Request for Judicial Notice.

CONCLUSION

Becoming a party to the Lease had knowable risks. BACC gambled that they would not materialize, and it lost.

Vallely, not BACC, was entitled to summary judgment. The judgment in favor of BACC must therefore be reversed with directions to enter judgment for Vallely.

May 24, 2000

Respectfully submitted,

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