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In Depth

Cases

From Canada

Burgeoning 'New Value' Competitive Bidding Requirement

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A debtor that owned a shopping center proposed a plan of reorganization that gave the spouse of the debtor's owner 100 percent of the equity of the reorganized debtor in return for a cash investment, but without any competitive bidding. The bankruptcy court had no objection to this result, but the 7th Circuit disagreed.

As the 7th Circuit noted, under § 1129(b)(2)(B)(ii) of the Bankruptcy Code (also known as the absolute priority rule): In order for a plan to be confirmed over the objection of creditors, the holder of a junior claim or interest is not permitted to receive any property under the plan "on account of such junior claim or interest." To get around this requirement, a debtor's equity holders have sometimes proposed to contribute "new value," and then argued that they are obtaining equity in the debtor based on the new value rather than on account of their junior equity interests.

However, in *Bank of America Nat'l Trust & Savings Assoc. v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 119 S. Ct. 1411, 143 L. Ed. 2d 607 (1999), the Supreme Court held that other potential investors must be allowed to bid when a plan proposes to allow existing equity holders to acquire equity in the reorganized debtor for new value.

In this case, there was secured debt of $10 million. Under the proposed plan, $300,000 would be paid immediately; the balance would be written down to $8.2 million as a secured claim, with the remaining deficiency treated as an unsecured claim. The post-confirmation secured loan was extended to 30 years, with "little to be paid until 2021." The interest rate was cut from 8.37% to 6.25%, and the loan did not include the protective features of the original loan, such as a lockbox for rents and various approval rights.

An insider of the debtor's owner (his wife) was given the right to purchase all of the equity in the reorganized debtor in exchange for cash. Initially, she was to acquire 100 percent of the new debtor equity for $75,000. The mortgage lender contended that this undervalued the debtor's assets, and made an offer of $600,000, together with payment of 100 cents on the dollar to other creditors (in contrast to the debtor's proposal to pay 15 percent on unsecured claims over five years). The debtor rejected the offer, although the proposed investment by the wife was increased to $375,000. The lender asked the bankruptcy court to condition acceptance of the plan on the wife's making the highest bid in an open auction. However, the court held that competition was not necessary and confirmed the plan.

Technically, the wife was not subject to the absolute priority rule since she did not hold a claim or interest junior to the bank's claim, and thus clearly was not receiving anything on account of a junior claims. However, the 7th Circuit concluded that insiders pose the same danger of diverting assets as the original equity holders and, consequently, should be subject to the same requirement for competition. (It also noted that the debtor's equity holder would receive value from the continuation of a salary as CEO of the company together with an increase in the family's wealth.)

The court drew an analogy to tax law examples:

(1) The exercise of a general power of appointment is treated as income to the holder; and
(2) The exercise of a discretionary power under a trust to direct assets to either the principal or his wife would result in income to the principal even if paid to his wife.

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Similarly, in this case, using the owner's authority to propose a plan that directs a valuable opportunity to his wife means that the absolute priority rule should apply, even though it is the owner's wife who is doing the investment.

The bottom line for the 7th Circuit was:

> Competition helps prevent the funneling of value from lenders to insiders, no matter who proposes the plan or when. An impaired lender who objects to *any* plan that leaves insiders holding equity is entitled to the benefit of competition. If, as [the debtor and the principal and his wife] insist, their plan offers creditors the best deal, then they will prevail in the auction. But if, as [the lender] believes, the bankruptcy judge has underestimated the value of [the debtor's] real estate, wiped out too much of the secured claim, and set the remaining loan's terms at below-market rates, then someone will pay more than $375,000 (perhaps a *lot* more) for the equity in the reorganized firm.

There is always an argument that § 1129(b)(2)(B)(ii) is triggered when existing equity holders offer new value without allowing others an opportunity to bid because they would not have the opportunity to acquire the new equity "but for" their control of the existing equity. However, an investment by an insider who does not hold a junior interest does not give rise to that argument.

Based on the court's characterization of the facts, the clear inadequacy of the proposed investment seems to drive the result in this case. This raises the question of how much further courts might be willing to go if they are faced with egregious facts.

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Speaking About Mortgages: Parol Evidence or the Document's Text?

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A recent decision by the California Supreme Court permits parol evidence to be admitted into evidence to show that a contract was tainted by fraud—even when the contention amounted to showing that the terms were other than what was printed in the document.[1] This decision probably shocks any California attorney who has practiced law here for less than the past 78 years, when *Bank of America v. Pendergrass* 4 Cal.2d 258 (1935), a mortgage case, first announced a contrary rule: putting the parol evidence rule above the fraud argument.

That old supreme court rule tended to become gospel in the minds of California attorneys, especially if they are unfamiliar with the fact that the rule was out of sync with what most other jurisdictions held (and from what the Restatements of Torts and Contracts asserted many years ago). On the other hand, for mortgage attorneys—whether they practice in California or elsewhere—the *Riverisland* decision is little more than a belated correction of a mistaken evidentiary ruling.

Riverisland allows a party to show that a mortgage loan arrangement was, in fact, different from what the documents said it was—in this case, that a debt restructuring agreement actually called for an eight-month forbearance and two additional pieces of security, even though the executed documents referred to only three months and eight additional parcels of land. Because that written agreement was integrated, signed and initialed at the appropriate places, the borrowers' testimony about the oral agreement clearly constituted parol evidence that would vary or contradict the writing. This would be a clear violation of CCP § 1856, unless it could fall within the fraud exception to the statute, which, under *Pendergrass*, it would not, because the claimed fraud was not "independent" of the variance.

When a document is involved in an ordinary transaction, the natural instinct of judges is to take it seriously—that is, to ascertain the meaning from its own content (its four corners) and to avoid allowing the use of extrinsic evidence to alter it. The parties are seen as masters of their own fate with regard to what they agreed on and signed, leaving it for judges merely to comprehend and enforce what they said.

But when the document involved is a mortgage, that principle of ordinary construction does not apply. It never has applied (and probably never will). Five hundred years ago, when the first mortgages were being written, they did not recite that they were mortgages or provide that the borrower was pledging her land to the lender and that the lender could go after the land if she failed to repay her loan when it came due. Such wording might have accurately described the intent of the parties, but would have violated the medieval rules regarding estates in land and transfers *in futuro*. Instead, to comply with the common-law technical requirements of the time, the document conveyed title to the lender immediately, but in fee simple language subject to the condition subsequent of timely payment of the obligation; any failure of the borrower to pay by "law day" simply enlarged that conditional estate into a fee simple absolute. While judges upheld the transaction as written, the chancellors in equity re-characterized the agreement from a conveyance into a mortgage and gave the mortgagor/borrower a right to pay late (her "equity of redemption"). To accomplish that, the mortgagee had to allow the borrower to testify that the transaction was in fact a loan, even though it had been written up as a sale.

Ever since then, equity courts have realized that if they want mortgagors to be able to pay their debts late and get back their properties, the judges could not possibly permit those rights to be lost by permitting mortgagees to rewrite the loan documents to destroy those rights (either directly or indirectly) by inserting artful language that would camouflage the fact that the transaction was really a loan secured by land.

Thus, for as long as there has been mortgage law, there has been a companion rule that parol evidence can be admitted, letting a borrower show that the document signed by the parties was really a mortgage—no matter how it was worded (like a deed or option or leaseback or whatever).[2]

Rules like that cannot comfortably coexist with an expansive parol evidence rule. Back in 1859, the California Supreme Court said:

> Evidence of these circumstances and relations is admitted, not for the purpose of contradicting or varying the deed, but to establish an equity superior to its terms. It is against the policy of the law to allow irredeemable mortgages, just as it is against the policy of the law to allow the creation of inalienable estates. Under no circumstances will equity permit this end to be affected, either by express stipulation, or the absolute form of the instrument. The rule that refuses the admission of parol evidence to contradict or vary written instruments is directed to the language employed by the parties. The rule does not exclude an inquiry into the objects and purposes of the parties in executing the instruments. Unless parol evidence can be admitted, the policy of the law will be constantly evaded. Debtors, under the force of pressing necessities will submit to almost any exactions for loans of a trifling amount, compared with the value of the property, and the equity of redemption will elude the grasp of the Court, and rest in the simple good faith of the creditor.[3]

Maybe the court forgot what it had held 78 years earlier when it decided in *Pendergrass* that parol evidence could not be used to show what the terms of that mortgage were. But, finally, in *Riverisland*, it corrects that mistake and puts mortgage law back on top again. If parol evidence can be admitted to show that a document is in fact a mortgage, the proponent is unlikely to be denied the opportunity of also showing what the terms of that mortgage were.

Drafting mortgages is inevitably different from drafting other documents because of the lack of sanctity that the equitable override has worked on the written word. It is more like residential leasing, where rent control, implied warranties of habitability and mitigation duties render a good many clauses ineffective (except that superior equities exist in commercial mortgages as well as residential ones). One probably negotiates differently when one knows that the judges are likely to ignore the language anyway.

Mortgage drafters and loan modifiers should still be concerned that their version of what historically occurred trumps the other side's narrative; however, those mortgage drafters and loan modifiers must not forget that simply putting it in writing and including an integration clause in the document is not the panacea that it is elsewhere. Devices such as bolder print, special initialing and detailed cover letters should be reconsidered. I anticipate that we will soon see many recommendations by transactional experts proposing new safe harbors to replace what *Riverisland* washed away. Although many of them may have useful evidentiary value, there are no magic mantras likely to dam up oral testimony entirely for the original documents or for their modifications—mortgage law just doesn't work that way!

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[1] *Riverisland Cold Storage v. Fresno-Madera Prod. Credit Ass'n* (2013) 55 Cal.4th 1169.

[2] *See, e.g.*, CC § 2925 ("The fact that a transfer was made subject to defeasance on a condition, may, for the purpose of showing such transfer to be a mortgage, be proved . . . though the fact does not appear by the terms of the instrument.") Or, CCP § 744 ("A mortgage of real property shall not be deemed a conveyance, whatever its terms, so as to enable the owner of the mortgage to recover possession of the real property without a foreclosure and sale.")

[3] *Pierce v. Robinson* (1859) 13 C 116, 125.

Be Careful What You Wish For: *Super Nova 330 LLC v. Gazes* and the Termination of Leases by Warrants of Eviction Under New York Law

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The Second Circuit Court of Appeals held, in *Super Nova 330 LLC v. Gazes (In re Association of Graphic Communications, Inc.)*, 2012 WL 3125241 (2d Cir. Aug. 2, 2012), that a commercial real property lease is "unexpired" for purposes of § 365(d)(3) of the Bankruptcy Code when the tenant under the lease has the power to revive the lease pursuant to applicable state law. More specifically, the Second Circuit found that under New York law a tenant's interest in a lease is extinguished only by the execution of a warrant of eviction and is not extinguished when the warrant is issued. Accordingly, even when a landlord obtains a warrant of eviction prior to a tenant's bankruptcy filing, the debtor-tenant retains an interest in the leasehold until the warrant is executed.

On the one hand, this means that a landlord may be entitled to payment of post-petition rent obligations as administrative expenses under § 365(d)(3) of the Bankruptcy Code until a warrant of eviction is executed or the lease is rejected. On the other hand, this decision may result in landlords being stuck in their tenants' bankruptcy cases even when a landlord has already contractually terminated the lease and obtained a judgment and warrant of eviction.

Somewhat surprisingly, the landlord was the appellant in *Super Nova 330*, arguing that the lease remained unexpired until the warrant of eviction was executed. Although in the short run there may have been a limited economic benefit from this outcome, in the long run the decision serves as a cautionary reminder: Be careful what you wish for. At least in New York, landlords will now be exposed to the delays, the uncertainties, the inability to mitigate and the costs associated with a bankruptcy of its tenant, notwithstanding a yeoman's efforts pre-petition to regain control of the premises.

This article discusses the Second Circuit's *Super Nova 330* decision and, along the way, summarizes the key provisions and mechanisms of bankruptcy law and New York property law relevant to the decision.

Background

Section 365(d)(3) of the United States Bankruptcy Code requires a debtor that is a tenant under an unexpired lease of non-residential real property to timely perform its obligations under the lease until the lease is assumed or rejected in the debtor's bankruptcy case. Courts hold that a lessor is entitled at least to administrative expense treatment for the amounts required to be paid under § 365(d)(3). The Bankruptcy Code does not define the term "unexpired," nor is the meaning of the term made clear by the legislative history of the Bankruptcy Code. Rather, bankruptcy courts look to state law to determine whether a non-residential real property lease is "unexpired."

The facts of *Super Nova 330* are as follows. A tenant under a non-residential lease of real property failed to make certain payments of rent. Its landlord demanded payment and, unsatisfied, began a non-payment proceeding in New York City Civil Court. The tenant did not defend the non-payment proceeding, and the court granted the landlord a default judgment of possession and issued a warrant of eviction. The day after the issuance of the warrant of eviction, and before the warrant was executed, the tenant filed a voluntary Chapter 7 bankruptcy petition.

Section 362 of the Bankruptcy Code provides for an automatic stay, protecting a debtor that files a petition under any chapter of the Bankruptcy Code. The automatic stay generally prohibits the commencement or continuation of litigation, lien enforcement and other actions that attempt to enforce or collect pre-petition claims. Section 362 also stays most actions that would affect or interfere with the property of the debtor or its estate. One notable exception to the automatic stay is the eviction of a debtor under a lease of non-residential real property that had terminated by the expiration of the stated term of the lease.

In *Super Nova 330*, the automatic stay prevented the landlord from executing its warrant of eviction once the tenant had filed for bankruptcy. Given the ultimate holding that the lease remained unexpired, the above-described exception to the stay did not apply. In order to execute the warrant, the landlord filed an unopposed motion before the bankruptcy court to lift the stay. The court granted the motion; the landlord executed the warrant almost three months after the warrant had been issued and the tenant had commenced its bankruptcy proceeding.

The landlord moved for payment of rent, attorney fees and pre-judgment interest pursuant to § 365(d)(3) for the period between the tenant's bankruptcy petition filing and the eviction date. The trustee for the debtor's bankruptcy estate opposed the motion. After discovery, the trustee moved for summary judgment, arguing that the lease had been terminated pre-petition when the warrant of eviction was issued and that, accordingly, the lease was not "unexpired" as required for relief under § 365(d)(3).

The bankruptcy court granted summary judgment for the trustee, concluding that the pre-petition issuance of the warrant of eviction terminated the landlord-tenant relationship such that there was no "unexpired" lease and therefore no right to payment under § 365(d)(3). On appeal, the district court agreed that the lease was not unexpired and affirmed the bankruptcy court's decision. On subsequent appeal, the Second Circuit vacated the lower courts' decisions.

Analysis

The Second Circuit began by noting that, because property interests are created and defined by state law, bankruptcy courts should look to state law to determine a debtor's interests in property, including leasehold interests. On the subject of warrants of eviction, § 749(3), New York Real Property Acts Law provides:

> The issuing of a warrant for the removal of a tenant cancels the agreement under which the person removed held the premises, and annuls the relationship of landlord and tenant, but nothing contained herein shall deprive the court of the power to vacate such warrant for good cause shown prior to the execution thereof.

Interpreting this provision of New York property law, the Second Circuit found that, while the issuance of a warrant of eviction cancels any existing lease, the tenant retains a residual interest in the lease until execution of the warrant. The residual interest is apparent in the fact that, prior to execution of a warrant of eviction, the state court may vacate the warrant for good cause and thereby reinstate the lease.

The court went on to compare New York law regarding lease terminations with Vermont law, as applied in its prior decisions in *Brattleboro Hous. Auth. v. Stoltz (In re Stoltz)*, 197 F.3d 625 (2d Cir. 1999), and *Canney v. Merchants Bank (In re Canney),* 284 F.3d 362 (2d Cir. 2002). Under Vermont law, a debtor may redeem and avoid ejectment up until the issuance of a writ of possession in an ejectment proceeding; but, once issued, the writ extinguishes the debtor's right to redeem. In contrast, New York law provides that a tenant may obtain *vacatur* of a warrant after it is issued and before its execution. The court noted that the automatic stay preserves a tenant's right to pursue its state court statutory remedy in the period between issuance and execution of a warrant of eviction: It effectively prevents a landlord from executing a warrant of eviction without bankruptcy court approval once a tenant files for bankruptcy.

Thus, the Second Circuit followed *Stoltz* and *Canney* in holding that a lease is "unexpired" for purposes of § 365(d)(3) when the tenant has the power to revive the lease under applicable state law. The court continued:

> Because in New York it is the execution and not the issuance of the warrant of eviction that extinguishes the tenant's interest in the lease, the lease is "unexpired" as that term is used in § 365(d)(3), until the warrant is executed.

Having found that a lease is unexpired until a warrant of eviction is executed, the court went on to note that it does not necessarily follow that the landlord was entitled to the rental payments and other costs it sought. Section 365(d)(3) states:

> The trustee shall timely perform all the obligations of the debtor . . . arising from and after the order for relief under any unexpired lease of non-residential real property, *until such lease is assumed or rejected*. (emphasis added)

Also, § 365(c) states that a lease cannot be assumed or assigned by the trustee if it is terminated under state law.

Accordingly, the Second Circuit raised the question of whether a "terminated" yet "unexpired" lease should be treated as presumptively rejected by the trustee or whether the court should require the trustee to affirmatively reject it in order to avoid liability for rent and other costs.

While noting that this issue was one of law and, therefore, could be decided by the Second Circuit as part of its resolution of the instant appeal, the Second Circuit instead remanded the issue for briefing and argument before the bankruptcy court, deferring to the bankruptcy court's specialized knowledge. Query, though, how a lease could possibly be treated as presumptively rejected and at the same time unexpired, as the Second Circuit held. The Second Circuit also vacated the bankruptcy court's finding that the tenant was not in possession of the space because both sides presented dramatically divergent accounts as to whether the landlord or tenant was in possession of the property in the months leading up to the eviction proceeding and bankruptcy filing. The Second Circuit noted that summary judgment was inappropriate where the two sides' accounts of the material facts were at odds.

Conclusion

The *Super Nova 330* decision clarifies that, under New York law, a lease is unexpired and a tenant retains a residual interest in the lease up until a warrant of eviction is executed. This holding provides protection for tenants, who may file bankruptcy at any point prior to the execution of a warrant of eviction and be assured both that the automatic stay will prevent the landlord from taking further action to execute the warrant without court approval and that its leasehold may remain subject to assumption and assignment. Landlords, such as the landlord who won the appeal in the *Super Nova 330* decision, may also benefit, in that they can argue that they are entitled to administrative rent up until a warrant of eviction is actually executed or the lease is rejected. The better result for landlords, however, may have been a finding that the tenant's interest in the lease terminated upon issuance of the warrant of eviction. That outcome could be more beneficial going forward because it would give landlords control of their premises and the ability to re-let and mitigate damages. For many landlords, control of the premises is more beneficial than the ability to preserve a claim for post-bankruptcy rent. Under the *Super Nova 330* decision, however, landlords must now wait until execution of a warrant of eviction or rejection of a lease in bankruptcy before knowing they are free of a delinquent tenant.

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Hidden Agendas: How Covert Mobilization Tactics Are Changing Retail Development Petitioning

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Citizen opposition can delay or even derail retail development projects. From heated demonstrations at zoning hearings to court appeals of local government decisions, protesting constituents can rapidly rack up project costs and put developers in a cold sweat. Now, imagine that the protestors are rallied by "agent provocateurs" who can, for a fee, hamstring development projects from the ground up. The resulting political pressure could make even the most innocuous development projects DOA.

This covert mobilization strategy is emerging as a powerful tool, and a potent weapon, in retail development. Developers are increasingly retaining third parties to drum up public support for projects, and their opponents—such as competing retailers and labor unions—are quietly benefiting from these covert strategies as well.

One prominent supplier of this service is self-proclaimed "land use politics expert" Saint Consulting Group ("Saint"). Saint makes its business deploying covert operatives that sway public opinion both toward and against development projects. Its strategy skirts competition laws by taking advantage of robust protections for free speech and government petitioning. And its approach works—with over 1,700 projects, Saint reports a success rate of 90 percent.

Whether fighting or hiring a covert mobilizer, developers and retailers should apprise themselves of the shifting petitioning landscape. This article provides a primer on the relevant issues, first by discussing common covert mobilization strategies, then by exploring the legal protections for these tactics, and concluding with guidance for those navigating either side of these disputes.

What Does Covert Mobilization Look Like?

Because covert mobilization is designed to pass for organic, homegrown opposition, it can be difficult to spot. However, there is often a common formula to these strategies. Becoming familiar with the usual acts and practices can help one identify covert mobilization as it is occurring (and, if necessary, fight against it).

Covert projects are typically handled by undercover agents with extensive experience in grassroots organizing. These agents generally do not identify themselves or whom they work for, particularly in competitive projects. Sometimes, agents use an assumed name and fabricate a personal history. In its exposé on Saint Consulting, the *Wall Street Journal* reported that one Saint agent uses pseudonyms taken from famous ballplayers; further, when he is assigned to oppose Wal-Mart developments, he tells citizens that a Wal-Mart development behind his parents' house ruined their plans for a comfortable retirement.

Agents mobilize citizens by using traditional grassroots strategies such as canvassing, gathering petition signatures and mailing literature. Canvassing also allows agents to identify constituents who can serve as mouthpieces for their cause. The most vocal advocates or opponents are placed on the front line to lead the campaign. Agents select persuasive citizens to attend public hearings and community meetings, and suppress the voices of community members on the other side. They may also hire lawyers and traffic experts to testify at these hearings on behalf of their cause.

If municipal officials decide petitions against the covert mobilizer's campaign, agents often retain a lawyer to appeal the decisions in court. In competitive projects, the agent may also coordinate nuisance lawsuits against the developer. In these cases, the goal may be to deplete the developer's finances through court costs and delay until it is forced to cut its losses and abandon the project.

Saint was recently involved in a series of lawsuits that successfully derailed a Wal-Mart development. Saint's activities were funded by SuperValu, which competes with Wal-Mart, and sought to keep the chain out of its market area. Despite Saint's grassroots opposition strategy, the municipality approved the Wal-Mart developer's zoning applications. Saint responded by retaining a lawyer to represent local citizens in court. Two lawsuits were filed against the municipality contesting the zoning approvals and one nuisance lawsuit was filed against the developer. The municipality and the developer, both unaware of Saint's and SuperValu's involvement, settled the cases in 2011 after four years of legal battles. The Wal-Mart developer sued SuperValu when it learned of the covert activity, but the lawsuit was unsuccessful for reasons discussed below. The developer lost millions in expenses and lost profits, and the project was abandoned. *Rubloff Dev. Grp., Inc. v. SuperValu Inc.*[1]

Labor unions recently used similar tactics to delay a shopping center development. The developer drew the ire of organized labor when it signed a lease with the nonunion supermarket Wegmans, and was informed that the unions would "fight every project [it] develop[s] where Wegmans is a tenant." The unions launched an antagonistic campaign shortly thereafter, using "surrogate plaintiffs" to lodge 14 legal challenges to the development. Many of these challenges were dismissed, and the remainder was withdrawn after the developer subpoenaed financial records to prove the unions' involvement. Although the development is scheduled to be completed, the unions' tactics considerably increased the developer's expenses. *Waugh Chapel South LLC v. United Food and Commercial Workers Union Local 27*, Case No. 12-1429 (4th Cir. Aug. 26, 2013).[2]

How Is Covert Mobilization Legal?

Many covert mobilization tactics are shielded by the First Amendment's right to political speech. This constitutional right is embodied by the *Noerr-Pennington* doctrine, which grants civil immunity to those who petition for government action. This immunity is absolute: It applies even when the tactics are unethical and the motive is anticompetitive. Saint openly touts the *Noerr-Pennington* doctrine as the legal loophole for its operation.

The facts in the seminal case are eerily similar to the covert opposition scenarios discussed. In *Noerr*, a group of railroads sought to protect their market share of the long-distance freight business from the encroaching trucking industry. They discretely directed a third party to launch an antagonistic campaign in the hope that public sentiment would encourage truck-hostile legislation. The Supreme Court held that the railroads' attempts to influence legislation were protected by the First Amendment, and any covert campaigning was also protected as incidental to that right. *Eastern Railroads Presidents Conference v. Noerr Motor Freight*.[3]

Although the doctrine arose under federal antitrust laws, courts have since extended *Noerr-Pennington* immunity to cases brought under the *National Labor Relations Act*, the *Racketeer Influenced and Corrupt Organizations Act* and a variety of common-law torts. It also has been broadened to protect other kinds of government petitioning, including lawsuit filings. In most jurisdictions, the use of covert land use politics will trigger *Noerr-Pennington* protection.

Are There Any Legal Boundaries to Covert Mobilization?

Noerr-Pennington immunity will almost always protect grassroots efforts to sway public opinion *toward* a development project. The purpose of these offensive operations is securing governmental approval for zoning and land use petitions, placing them squarely within *Noerr-Pennington*'s protection. But when there is no intention of influencing government action—for instance, if a lawsuit is filed solely to harass the defendant, without regard to its probability of success—courts do not extend constitutional protection.

However, it is difficult to prove a litigant's subjective motivations, and courts are wary of removing First Amendment protection. Thus, the Supreme Court developed an objective test: If the lawsuit is actually successful, then plaintiffs are given the benefit of the doubt and all of their related covert action is protected. Put differently, a plaintiff whose only goal is to exhaust the defendant may be immune from liability if its legal challenges incidentally prevail.

This result was reached in the *SuperValu* litigation discussed above. The Wal-Mart developer argued that SuperValu filed lawsuits without regard to their merits and for the sole reason of derailing the development. Thus, it urged that SuperValu could not enjoy *Noerr-Pennington* protection. The court disagreed. It reasoned that since the lawsuits were settled, they were actually successful and satisfied the Supreme Court's objective test. Thus, it gave SuperValu's subjective motivations the benefit of the doubt and protected its covert conduct from liability.

However, the opposite result was reached in the Wegmans dispute. As discussed above, each of the labor union's claims were either dismissed or voluntarily withdrawn. Consequently, the court observed that "the vast majority of the legal challenges failed demonstrably," and declined to extend *Noerr-Pennington* immunity. The case is currently pending resolution, and the unions must now defend illegal boycotting claims without constitutional protection.

What Can I Do About Covert Mobilization?

It is crucial that those involved in the zoning process stay informed of these trends. Since most covert mobilization is constitutionally protected, developers and retailers may benefit from this powerful knowledge. Those who campaign offensively for their own developments are particularly likely to be immune from liability. But to avoid the result reached in the *Wegmans* case (no protection), practitioners who campaign against other developments should keep current on legal developments and avoid toeing the line of harassment too closely.

Further, practitioners who encounter citizen opposition to their own development projects should investigate for evidence of covert involvement. In the *SuperValu* settlement, for instance, the developer's ignorance of SuperValu's involvement may have contributed to the lawsuit settlement that precluded its recovery. Conversely, the developer may recover in the *Wegmans* case precisely because it was aware of the unions' involvement. As noted, the unions voluntarily dismissed 9 of the 14 legal challenges after the developer subpoenaed financial records to prove their involvement. Had these claims prevailed or settled, the court would have likely extended *Noerr-Pennington* protection.

Municipalities should also monitor citizen opposition for signs of third-party funding. If the local government can expose the root of the opposition during the hearing process, it can base its decisions on the merits instead of in response to the orchestrated public pressure. This knowledge may also help a municipality defend appeals of its decisions—if it can establish that the party behind the appeals is not directly affected, it may be able to dismiss the lawsuits for lack of standing.

Conclusion

Developers, retailers and municipalities should closely monitor citizen opposition for signs of concealed competitive involvement. Developers may also consider applying these covert strategies as a useful tool to gain public support for their projects. And although those who use these tactics to derail developments can find a powerful defense in *Noerr-Pennington*, they should bear in mind that its protections are not absolute.

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[1] 863 F.Supp.2d 732 (N.D. Ill. 2012).
[2] 863 F.Supp.2d 732 (N.D. Ill. 2012).
[3] 365 U.S. 127 (1961).

Overcoming Environmental Obstacles to Retail Development: Five Tips for Avoiding Environmental Deal Killers

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Environmental issues can be deadly to real estate deals. Unfortunately, real estate professionals too often seem to address potential environmental issues in extreme ways.

One way is to avoid investigating or acknowledging them, for fear a deal will be derailed if any such issues are brought to light, which is known as the "ostrich syndrome." While the ostrich syndrome often results in a deal going forward, the opportunity to allocate costs equitably among parties to remediate any environmental issues is lost. However, when such problems finally come to light, the ostrich syndrome usually leads not only to extreme buyer's remorse but also possibly spurring unwelcome litigation when the unexpected environmental liability eventually surfaces.

Another way is to overreact by killing the deal if even a minor environmental issue is identified, out of concern that the costs of addressing such a problem will escalate uncontrollably, to the point of making the project infeasible. However, while this approach usually avoids the consequences of the ostrich syndrome, it inevitably results in the recurrence of missed opportunities that could well have proven profitable, if only the right steps had been taken to assess and resolve such environmental concerns.

Neither extreme scenario need be the case for your deal, though, if you address potential environmental risks with an informed, practical approach to environmental due diligence. Whether you are a seller or a buyer, a developer, a prospective tenant, a landlord, or another stakeholder, this article offers five critical tips to help protect your next deal from becoming a casualty of poor environmental risk management.

Tip #1: Learn the Basic Concepts of Environmental Liability.

Generally, dealing with contaminated soil and/or groundwater poses the most significant and costly environmental risks to retail development. But do not ignore other environmental challenges beyond the scope of this article, such as wetlands and endangered species. To manage the risk associated with potentially contaminated property, you must have at least a basic understanding of the typical environmental liability schemes under statutory and common law at the federal, state and sometimes local levels. You can accomplish the keys to a successful deal—investigating, defining and then allocating the risk among the parties—by initially performing appropriate environmental due diligence (as discussed in Tip #4 below). However, to execute effective due diligence, you must understand the pertinent legal framework that governs when and where such liability may attach.

As a general rule, statutory environmental liability is strict, joint and several. Thus, an owner, operator or possibly lessee of contaminated property can be held liable for the total costs of remediation and other consequences, including migration of such contaminants onto other property, even though they did not originally contaminate the property at issue. The most significant law affecting real property from the environmental perspective is the *Comprehensive Environmental Response, Compensation and Liability Act* ("CERCLA"),[1] commonly referred to as "Superfund." CERCLA is a federal statute that applies to any release of "hazardous substances" at a facility. Under CERCLA, liability for "costs of response" (typically, costs of remediation and related expenses but generally excluding attorney fees) can be asserted against the current owner or operator of a facility, as well as past owners or operators at the time of a release of hazardous substances at the facility.[2] *Keep in mind: Lack of knowledge is no defense.*

Many states have adopted almost identical CERCLA laws, which are known as Baby Superfund statutes, and have their own environmental statutes as well. Individual states can impose duties on current owners or operators to investigate or remediate contamination—again, often without regard to fault. Also not to be ignored are traditional common-law causes of action such as public and private nuisance, negligence, trespass and even ultra-hazardous activity. The criteria for proving a claim under common law may actually be less burdensome than proving a CERCLA claim, and plaintiffs' remedies can be more expansive—such as injunctive relief to force cleanup of a property, which is generally not available under CERCLA. Such common-law claims are generally not preempted by statutory enforcement schemes, so environmental lawsuits often include a combination of statutory and common-law causes of action.

Tip #2: Understand and Know How to Establish Defenses to CERCLA Liability.

Fortunately, there are some helpful defenses to statutory environmental liability available. For retail development and leasing, the two most relevant defenses under CERCLA are the so-called "Innocent Landowner"[3] and the "Bona Fide Prospective Purchaser."[4] While these defenses have somewhat different requirements and are used in different circumstances, both require that a party seeking to own or lease real property initially conduct All Appropriate Inquiry ("AAI") into the environmental condition of the property. (AAI will be explained later, especially in Tips #3 and #4.)

Generally, the Innocent Landowner defense is used when contamination is discovered on a property where the conditions of the contamination were not and could not have been discovered prior to purchase, despite proper execution of AAI. The Bona Fide Prospective Purchaser ("BFFP") defense is used when a prospective landlord or purchaser of property discovers, in the course of AAI, that contamination does exist on the property but wishes to go through with the deal anyway. Tenants can either piggyback on the landlord's BFFP status, if the landlord qualified as a BFPP when it acquired the property, or qualify for the BFFP defense in their own right if they follow the required procedures themselves (i.e., achieve AAI and exercise due care thereafter).

Both the Innocent Landowner and BFFP defenses provide that, once the defense is established, the party utilizing the defense has no CERCLA liability for the property as long as certain subsequent duties are fulfilled—e.g., the property owner takes "due care" by not exacerbating the contamination, by preventing exposure, by stopping/preventing any continuing or future releases, and by allowing access to the government or liable parties for remediation activities.[5]

In addition, both defenses require that the acquiring party have no affiliation with the polluting party—e.g., a liable party cannot simply divest the property into an LLC or similar entity in order to claim the defense based on the performance of AAI at that time.

To maximize chances for the successful assertion of either defense, be sure to consult experienced environmental counsel for an opinion (1) as to whether AAI has been achieved in the course of the environmental investigation, and (2) to confirm the legal sufficiency of other pertinent criteria.

While you may have an environmental consultant, you also need an environmental attorney; likewise, do not assume that your trusty real estate attorney has the experience and knowledge to deal effectively with environmental issues.

A few caveats regarding environmental statutory defenses are in order:

- The Innocent Landowner and BFFP defenses outlined above are effective only against federal CERCLA liability. While states with Baby Superfund statutes may have similar defenses, not all state versions of CERCLA have necessarily kept up with the revisions and expansions to CERCLA defenses that have occurred over the years. (E.g., the BFFP defense was added as a result of an amendment to CERCLA in 2002.)
- The Innocent Landowner and BFFP defenses are not applicable at all to common-law causes of action.
- Keep in mind that as useful as the CERCLA liability defenses are, the property is still contaminated. Due care requirements must be fulfilled to maintain the defense, which may be expensive and inconvenient for the owner/operator. Moreover, because assertion of the defense does not affect the contamination itself, the property may well be devalued; divesting the property may become much more difficult, as well as result in a financial loss.

Never pay full price for contaminated property, based on an expectation that you will be able to assert CERCLA defenses to liability. Be sure to factor in the financial impact of such contamination at the negotiation stage. And, when acquiring potentially contaminated property, do not overemphasize the goal of being able to assert the CERCLA liability defenses, in light of any other complications associated with taking title to or leasing contaminated property.

Tip #3: Know What AAI Entails.

The specific requirements are set forth under CERCLA, 42 U.S.C. § 9601(35)(B)(iii), and are fleshed out in the AAI regulations.[6] In addition, numerous helpful guidance documents are available on the U.S. EPA website.

In general, AAI requires that a qualified "environmental professional" conduct an investigation that includes (but is not limited to) a visual site inspection, along with a review of reasonably available governmental and historical records [e.g., a chain of title documents, environmental databases, city directories, aerial photographs, fire insurance (Sanborn) maps; searches for recorded environmental cleanup liens; and interviews with current or prior property owners]. Such exercises are intended to discover whether certain activity (or activities) likely resulted in the release of hazardous substances on the property. The shortcut to designing an AAI inquiry for a given property is to follow the ASTM ("American Society for Testing and Materials") Standard Practice requirements for Phase I Environmental Site Assessments ("ESAs") set forth in its publication E1527-13 (a copyrighted document), which has been approved by U.S. EPA and is available for purchase from ASTM on its website. Phase I ESAs are discussed in more detail below.

Avoid a common trap by ensuring that a viable Phase I ESA is on hand on the date of acquisition of the property. Under AAI, the environmental investigation must be conducted within one year prior to the date of acquisition of the subject property, although certain critical aspects of the investigation (e.g., the visual inspection, certain record reviews, and interviews of current and/or prior owner/operators) must be conducted or updated within 180 days of the acquisition of the property.[7] The 180-day requirement therefore gives an effective shelf life of only 180 days for an AAI-compliant Phase I.

To ensure that the earliest of these tasks is no more than 180 days prior to taking title to the property, "cheating" is not allowed. For example, you cannot hold off on finalizing a draft report, as the critical date for calculating the viability of a Phase I ESA is not the date of the report, but the earliest date of performing each of the required tasks (such as the site inspection). Although AAI rules allow for certification of prior Phase I ESAs to be used by a prospective owner, the tight 180-day timing requirement, for the most part, eviscerates prior Phase I ESAs from past investigations being used to satisfy AAI; however, such prior reports can be very helpful in performing the current Phase I investigation.

In general, it is wise to provide your environmental attorney with a chance to review the draft Phase I, to check for AAI compliance, and to offer a second set of eyes and experience that add to the assessment of the overall environmental risk for the deal.

Tip #4: Insist on Proper Environmental Due Diligence.
While qualifying for the appropriate environmental statutory defenses (explained above) is unquestionably an important aspect of conducting environmental due diligence, the more important overall goal is to be able to identify and quantify the environmental risk involved in the acquisition or lease of a property. Environmental due diligence is the preliminary line of defense for parties in property or business transactions to avoid the unintentional assumption of environmental liability. Environmental due diligence allows a party to (1) avoid entering a transaction with unacceptable environmental risks and (2) negotiate to allocate liability of a known environmental risk.

In a lease situation, environmental due diligence also helps ensure that the property is suitable for the lessee's needs and enjoyment of the property (e.g., to make sure no contamination exists that might cause risk of hazardous vapor intrusion). Once the space is already developed, lessees tend to downplay or even ignore environmental concerns, as the lessee does not own the property. After all, many commercial leases clearly state that the landlord, not the tenant, is responsible for any preexisting environmental conditions. However, proper environmental due diligence can also establish a baseline of the environmental condition of the property, which should avoid disputes at the termination of the lease regarding liability for known contamination.

When negotiating a purchase agreement or a lease, allow sufficient time to perform proper due diligence—usually, within 60 days as the bare minimum necessary, but 90 or 120 days (or more) is much more desirable. Such contracts should also mandate that the seller/lessor provide all documents related to the environmental condition of the property, including prior reports, correspondence, notices of violation, and so on.

As noted above, the shortcut to achieving AAI is to perform an ASTM-compliant Phase I ESA. However, as will be explained below, due diligence does not necessarily stop with a Phase I ESA, especially if the Phase I report reveals one or more Recognized Environmental Conditions ("RECs") that typically require further examination with a Phase II investigation. Because the hallmark of a Phase II investigation is invasive testing of soil and/or groundwater for contaminants (not included in Phase I), the contract should also provide for such testing of the property, if recommended as a result of the Phase I investigation. While sellers and/or landlords are sometimes reluctant to agree to such testing, proceeding with the transaction without such testing in the face of a recommendation from an environmental professional to do so typically forecloses the opportunity to adequately assess and manage the environmental risk of the deal.

Once such environmental issues are defined and quantified as the result of one or more Phase II investigations, the next step is, typically, to contractually include a remediation or cleanup into a development deal (or provide for purchase price discounts or other equitable options). These issues, which are beyond the scope of this article, can include options such as whether the cleanup will be performed pre- or post-closing, whether the buyer or seller will perform the cleanup, how the cleanup will be funded (escrows, holdbacks, insurance policies, and so on), how to ensure that the cleanup is actually performed correctly (and providing for self-help or another remedy if it is not), as well as providing for appropriate closure from appropriate regulatory authorities. Experienced environmental counsel should be engaged to assist in handling these issues, as well as providing for the contractual allocation of future environmental liability between the parties.

Tip #5: Understand What a Phase I ESA *IS*, and What It *IS NOT*.
While Phase I ESAs are wonderful tools for assisting with environmental due diligence, by their very nature they have certain limitations. You must know when additional environmental due diligence is appropriate. Think of a Phase I investigation as an exercise in issue spotting or finding a problem, not necessarily correcting it. Typically, the focus of a Phase I ESA is to identify RECs.

According to the latest ASTM practice, E1527-13, RECs are defined as "the presence or likely presence of any hazardous substances or petroleum products in, on, or at a property: (1) due to any release to the environment; (2) under conditions indicative of a release to the environment; or (3) under conditions that pose a material threat of a future release to the environment." If one or more RECs are identified in Phase I, the environmental professional performing Phase I testing will commonly recommend (preferably in a letter separate from the Phase I report itself) a Phase II investigation or explain why an additional investigation is not necessary, despite the presence of one or more RECs. (E.g., if Phase II testing results are already available from prior investigations, such data may negate the usefulness of any additional testing.)

Because Phase I investigations, by definition, do not include invasive testing, they do present obvious limitations. This is why a Phase II investigation may be appropriate. But even beyond that obvious limitation, the protocol for a Phase I may miss significant environmental issues on a property if there are no "clues" that lead the environmental professional to suspect or identify the existence of a REC. Yet, the results of the Phase I investigation are ASTM-compliant.

For example, consider a now-vacant lot that was once used for the "midnight dumping" of drums of waste or chlorinated solvents. There is no record of such use in typical documents that are reviewed in the course of a Phase I investigation (e.g., city directories or underground storage tank records). A visual inspection of the property does not identify distressed vegetation or soil staining or any obvious evidence of the dumping. Yet, over time, serious soil and/or groundwater contamination, resulting from the solvent dumping, has impacted the property. The Phase I ESA was not defective or non-compliant with ASTM because it did not reveal the presence (or at least the possibility) of such contamination. (Note, however, that if the U.S. EPA were to bring an enforcement action, or if an adjacent property owner were to sue due to damage from migrating contaminants, then this may be a good example of an appropriate situation for raising the BFFP defense under CERCLA.)

In summary, a Phase I investigation:

- Does NOT guarantee that a site is clean
- May NOT reveal every possible environmental problem on the property, nor define the extent of the problem, if any
- Is NOT an environmental compliance audit (if there is also an operating business on the property that requires permitting) and
- Does NOT necessarily guarantee that a property purchaser will be able to claim a defense against future environmental liability.

BONUS Tip: Keep Up on New Developments

The field of environmental due diligence continues to evolve and change. The industry standard for what is considered acceptable and appropriate due diligence has advanced from what it was just five years ago. The new ASTM standard for Phase I ESAs (E1527-13) has supplanted an older standard (E1527-05) and includes greater focus on the hot topic of vapor intrusion, among other issues.

An excellent (and inexpensive) way to keep up with the latest developments is to use environmental consultant and attorney mailing lists, as well as e-mail notifications for newsletters and client alerts. Such publications are generally brief, timely and written for non-environmental professionals. When environmental issues come up on your projects, you will be well-informed and ready to work with your environmental consultant and environmental attorney to meet the challenges inherent in managing environmental risk.

Conclusion

While one article barely scratches the surface of the totality of environmental issues that must be investigated and dealt with to manage environmental risk properly and ensure a successful project, following the above five tips will help you confront and overcome environmental challenges that might otherwise seem insurmountable. Of course, there are necessary steps beyond due diligence—e.g., negotiating the allocation of environmental liabilities in the context of the deal and incorporating them into an agreement.

In sum, there is no substitute for developing a stable of reliable and competent environmental consultants—at various price points, geographic reach and level of ability—to call upon when issues come up. Finally, experienced and practical environmental counsel will work with your real estate attorney on each deal to ensure success.

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[1] 42 U.S.C. § 9601 *et seq*.
[2] 42 U.S.C. § 9607(a).
[3] 42 U.S.C. § 9601(35).
[4] 42 U.S.C. § 9601(40).
[5] See 42 U.S.C. § 9601(40)(D).
[6] 40 CFR § 312; original promulgation at 70 Fed. Reg. 66070 (Nov. 1, 2005).
[7] 40 CFR § 312.20(a).

Contradicting the Integration Clause in California Fraud Claims: 76-Year-Old Precedent Overturned

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It did not take long for courts—in two commercial retail lease disputes—to cite a 2013 California Supreme Court decision concerning the parol evidence rule. *Riverisland Cold Storage v. Fresno-Madera Production Credit Ass'n,* 151 Cal. Rptr. 3d 93 (2013), overturned long-standing California law that prevented the introduction of parol evidence to contradict the terms of a written contract in cases involving allegations of fraud. This case puts California squarely within the majority rule in the United States and should interest landlords and tenants (and their lawyers) alike.

The *Julius Castle* Decision

The *Riverisland* decision affected the outcome of *Julius Castle Restaurant, Inc. v. Payne*, 157 Cal.Reptr.3d 839 (Cal.App. 1 Dist., 2013). Here, the plaintiff restaurant owners sued their landlord for fraud relating to the disrepair of the leased premises. According to the plaintiff, the parties met and negotiated a lease for restaurant space, during the course of which the landlord agreed to make any necessary repairs. The landlord indicated that he had made extensive renovations to the space, and impliedly (if not expressly) represented that the equipment was in working order. The lease the parties ultimately executed stated that:

> Tenant acknowledges that as of the date of this Lease, Tenant has inspected the Premises and all improvements on the Premises and that the Premises and improvements are in good order, repair and condition.

The lease also contained a standard integration clause that stated in part:

> Any agreement or representations respecting the Premises or their leasing by Landlord and Tenant not expressly set forth in this instrument are void.

Upon taking possession of the restaurant, the tenant discovered numerous permitting issues relating to the renovations completed by the landlord, as well as malfunctioning equipment and utilities. The tenant expended its own money for many of the repairs due to the delayed response and/or neglect by the landlord to do so. Eventually, the tenant withheld rent in order to reimburse itself, resulting in lawsuits filed by each party against the other, including the tenant's fraud claim against the landlord.

Pre-Riverisland Era

In the pre-*Riverisland* era, the plaintiff/tenant would likely not have prevailed on its fraud claim since the basis was that the landlord/defendant's misrepresentations regarding the condition of the leased space persuaded the plaintiff to move forward with the lease. The defendant's misrepresentations were contradictory to the terms of the executed lease, thereby making such testimony parol evidence. Given the *Riverisland* decision, however, the court allowed the evidence; the jury agreed with the plaintiff and the plaintiff prevailed on its fraud claim.

The *Thrifty Payless* Decision

The second case to cite *Riverisland* is *Thrifty Payless, Inc. v. The Americana at Brand, LLC,* (Cal. Ct. App. 2013). Here, Thrifty Payless, Inc., negotiated a lease for space with the landlord in a shopping center. Negotiations began with a letter of intent ("LOI") that set forth estimated expenses relating to common area maintenance charges, taxes and insurance. Prior to lease execution, the landlord provided the tenant with (1) a budget breakdown, (2) the square footage of the center participating in the additional rent charges and (3) the estimated pro rata percentage of 2.2 percent for the tenant. The letter from the landlord that transmitted this information stated that the costs were "purely estimated values."

The parties subsequently executed a lease, and the tenant opened for business in 2008. The lease defined the tenant's pro rata share as the calculation of the floor area of the leased premises divided by the floor area of the leased and occupied portions of the shopping center with a carveout for certain types of tenants that contributed to the additional rent charges in another manner. The executed lease included neither the estimated expense amounts from the LOI nor the specific pro rata percentage figure. The lease contained an integration clause similar to the *Julius Castle Restaurant* case, and specifically stated that the terms of the lease superseded any prior writings, including LOIs between the parties.

In 2009, the tenant became obligated to pay its first full year of the additional rent expenses. The landlord charged the tenant a pro rata share of 5.67 percent—which was more than double the LOI estimate. The actual amounts charged totaled $610,000 as opposed to the estimated amount of $267,400. The tenant filed suit that included, among others, claims for fraud and negligent misrepresentation. The tenant contended that the landlord's superior knowledge of the project meant that it knew, or should have known, when it made its representations that they were false or that the representations had no reasonable basis to be true.

At the hearing on the defendant's demurrer, the plaintiff argued that it learned other tenants had been quoted substantially higher pro rata share percentages than the plaintiff, and that a special deal had been cut with one large tenant to charge it less than its pro rata share. The defendant's arguments included the fact that the express terms of the lease control, and extrinsic evidence (i.e., parol evidence) to alter or add to these terms, is not permitted. The trial court granted the defendant's demurrer, finding that the estimates were mere estimates and that it was up to the plaintiff to verify the dollar amounts.

On appeal and in the wake of *Riverisland*, the court agreed with the plaintiff and determined that the trial court erred in granting the demurrer with respect to the fraud and negligent misrepresentation claims. The court cited *Riverisland* in its decision that the grossly inaccurate estimates in the LOI and budget breakdown, as well as the arguments by the plaintiff regarding the pro rata shares of other tenants, are permissible—even in light of the express terms of the integration clause. Consequently, the plaintiff was granted leave to amend its complaint as necessary.

The Impact of *Riverisland*

Riverisland clearly affected the outcome of the cases cited herein, both of which likely would have had opposite results less than two years prior. It is quite possible that the *Riverisland* ruling will result in less ability to dismiss an action summarily in California and more actions heading to trial based on extrinsic evidence that contradicts the written agreement. On the other hand, fraud is a difficult action to maintain, and each of the five elements of fraud must be pled with specificity and proven by competent evidence. These elements are: (1) a misrepresentation of a material fact, (2) knowledge on the part of the defendant that the statement is untrue, (3) intent on the part of the defendant to deceive the alleged victim, (4) justifiable reliance by the alleged victim on the statement, and (5) injury to the alleged victim as a result. *Riverisland* only addresses one element—that of misrepresentation.

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The Basics of the EB-5 Immigrant Investor Pilot Program

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The EB-5 Regional Center Program ("Program") was implemented by Congress in 1992 as an effort to stimulate the U.S. economy. Its purpose is to create jobs for U.S. workers in economically disadvantaged geographic areas of the country, while at the same time providing a new opportunity for foreign immigrants to become lawful permanent residents of the United States.

The Program is called "EB-5" because it is the last of five employment-based categories for visas issued by the U.S. Citizenship & Immigration Service ("USCIS").

This innovative Program is designed to incentivize foreign/immigrant investors to invest funds in an economic unit known as a "Regional Center." This structure allows multiple investors to be pooled together to provide greater investment power for financing job-creating developments or businesses.

This is how it works:

- A Regional Center is a private or public third-party-managed investment vehicle that collects pooled investments and provides capital infusions to domestic businesses and real estate projects. The Regional Center is responsible for making sure each immigrant investor satisfies the requirements of the EB-5 Program.
- Each foreign investor must make a minimum investment of $500,000 into an approved Regional Center project located within a targeted employment area ("TEA"). A TEA is a defined geographic area that (i) is in an urban setting (part of a metropolitan statistical area) that is experiencing an unemployment rate of at least 150 percent of the U.S. national average; or (ii) is a rural area (outside of a metropolitan statistical area). Locations are designated for TEA status by a state government or an economist, and must be approved by the USCIS. A TEA must be contiguous, clearly delineated, and can range in size from a single Zip Code or census tract up to large areas of multiple counties, a city or other political subdivisions.
- The project that is being invested in, must be a new commercial enterprise within a Regional Center. Typically, the Regional Center will create a limited partnership or a limited liability company to serve as the new commercial enterprise that may invest in unrelated companies and real estate projects throughout the TEA.
- For each $500,000 investment, 10 or more new permanent jobs must be created within the TEA within two years after the investment. The Regional Center is responsible for ensuring that the requisite jobs are created; the EB-5 Program allows the jobs creation requirement to be met with both direct and indirect (e.g., construction positions) new jobs—demonstrated through economic studies or other reasonable methodologies. New positions must be given to U.S. citizens or other lawfully employed immigrants and cannot include positions held by the applicant or his or her family.
- Investor applicants to the EB-5 Program must demonstrate that they meet all of the requirements prior to filing with the USCIS. If it is determined that the investment criteria are met and properly documented, an investor may be granted conditional permanent residence status for a period of two years. At the end of the conditional period, if all of the EB-5 Program requirements continue to be met, lawful permanent residency status may be granted to the investor. Five years after the initial grant of conditional permanent residence, the investor may apply for U.S. citizenship.
- In exchange for investing $500,000 in an EB-5 Regional Center, the investor/foreign national and his or her immediate family (spouse and unmarried children under 21) can obtain lawful permanent residence in the United States. Lawful permanent residency is commonly referred to as a "green card." Obtaining a green card through the traditional immigration process can take decades and often results in denial for dozens of different reasons. Accordingly, the ability to obtain a green card in a comparatively short amount of time, and with fairly good chances of approval by investing through the Program, is enormously attractive to many foreign nationals.
- The investors are required to "direct and control" their investment, or investments. To satisfy this requirement, investors are typically made limited partners or members in a limited partnership or limited liability company that serves as the entity making the investment. Investors are not required to live within any certain proximity to the commercial enterprise where the capital investment is made.

Projects Suitable for EB-5 Regional Center Financing

As conventional lending standards tightened during the recession and capital funding for new projects remains scarce, the EB-5 Program provides significant low-cost financing for real estate projects in undercapitalized U.S. markets.

The USCIS sets aside 3,000 EB-5 visas per year for qualified individuals seeking permanent resident status who invest in a designated Regional Center, resulting in a potential of $1.5 billion of capital created annually.

The most attractive feature of the EB-5 financing to a real estate developer is that it can be obtained at low interest rates because the investors are generally much more interested in obtaining the green card than in receiving any particular minimum return on their investment. The pooled invested funds can be used as equity, mortgage debt or mezzanine debt for development of the project within the Regional Center.

While permanent residency is the main reason that most investors are drawn to the EB-5 Regional Center investments, investors also receive a modest return on their investment. They will expect to be paid back their capital investment in approximately five years.

Because of the jobs creation requirement, real estate projects such as offices, full-service hotels, manufacturing facilities, entertainment venues, shopping centers and mixed-use projects are good candidates for EB-5 Regional Center financing because they require significant numbers of employees to staff them.

For example, the Atlantic Yards project, set on 22 acres in downtown Brooklyn, NY, obtained approximately $228 million in EB-5 financing. The project, which is anchored by Barclays Arena (home of the Brooklyn Nets and also serves as an entertainment venue), will include approximately 6 million square feet of residential space, 247,000 sf of retail use, approximately 336,000 sf of office space and 8 acres of publicly accessible open space. Proponents of Atlantic Yards estimate that the project will create approximately 17,000 construction-related jobs and up to 8,000 permanent jobs.

On a smaller scale, the Virginia Atlantic Regional Center ("VARC") received its Regional Center approval from the USCIS in November 2013. Through its developer, VARC anticipates breaking ground on its first project, AsiaTown, this year. AsiaTown is slated to be a mixed-use, Asian-themed development featuring shops, restaurants and other services on 10.6 acres in Virginia Beach, VA.

Proponents of the development anticipate that AsiaTown will cost about $14.5 million to build in two phases. Under the EB-5 Program, AsiaTown's developer intends to seek foreign investment for a projected 250 jobs (primarily in construction and supplies), build on the 32,000 sf of retail space and construct a 40,000-sf office building.

Local communities will benefit economically through new tax revenues, jobs creation and the additional source of capital provided for improvements to the communities through the foreign investments in the new commercial enterprises.

Regional Center Application and Designation

Regional Center status is obtained by filing an application with the USCIS. A total of 439 Regional Centers has been approved through November 2013.

The application for a Regional Center must contain the following:

- An explanation and business case proposal of how the investment will promote growth, create jobs and generate domestic investment within the TEA
- Details on the source from which the capital is derived
- Predictions on the positive impacts the Regional Center will have within the TEA. Potential new jobs can be proved with multiplier tables, feasibility studies, and other economically or statistically valid forecasting devices

Unfortunately, it is difficult to predict how long it takes to make a decision on a Regional Center application. The USCIS estimates that the process takes approximately 15 months for approval; however, current turnaround time is running significantly longer (i.e., 17 months or more).

During the Regional Center approval process, potential investors are solicited directly or through a network of finders in various parts of the world.

Upon USCIS approval of the Regional Center, investors are given complete marketing information about the project, as well as the offering documents and subscription agreements that will be used for their investments.

Upon USCIS approval of the region for TEA status, investors will deposit their $500,000 into the Regional Center and file I-526 conditional visa applications with the USCIS. If approved, this will provide conditional permanent residence to the investors and their families.

Upon approval of the I-526 applications, which generally takes five to six months, the Regional Center may begin making investments into designated projects.

Due to current USCIS delays, it can take as long as 15 to 18 months from starting the Regional Center approval process until actually funding the investment. The EB-5 Program, therefore, is best suited for (i) ground-up developments that are early in the entitlement phase or (ii) shovel-ready projects that would use the EB-5 funds as a replacement for construction or other short-term financing.

Finally, after two years, USCIS will review the project to confirm that:

- The required jobs were created and sustained
- Each entire $500,000 was invested into legitimate projects located within the TEA, and
- The capital investments came from lawful and legitimate sources

These requirements are established by the investor, who files an I-829 application to remove conditions. Approval of the I-829 by USCIS grants the immigrant/investor and his or her family true permanent resident status.

The entire process for receiving the green card takes about 30 months.

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Cases

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LEASES—CO-TENANCY

The United States District Court for the District of Connecticut granted summary judgment in favor of the tenant, allowing the tenant to pay abated monthly rent for the life of the lease after the closing of Borders. *Kleban Holding Co. v. Ann Taylor, Inc.*, No. 3:11-CV-01879 (VLB), 2013 WL 6191904 (D. Conn. Nov. 26, 2013).

This case is a good example of the need for careful lease drafting and construction. Ann Taylor leased retail premises in a shopping center in Fairfield, CT. The lease contained a co-tenancy clause containing two sections that provided:

(a) Opening: The delivery date did not occur until 80 percent of the retail area of the center was under construction and Borders and two specifically named major retailers executed leases, but the landlord was permitted to replace the other two specifically named major retailers with a suitable replacement tenant.
(b) Operating: In the event that Borders or 50 percent of the retail space, excluding the tenant, was not open and operating, the tenant was entitled to abate the rent and instead pay 5 percent of gross sales until the tenants meeting the foregoing requirements were again open and operating.

Although Borders timely opened and operated, it closed its store on May 16, 2011, in connection with its bankruptcy filing. The landlord replaced Borders with Book Warehouse, which was later replaced by a university bookstore. Two months after Borders vacated the space, Ann Taylor began paying the abated rent.

The landlord initiated the lawsuit seeking full rent under the lease. Ann Taylor contended that the lease entitled it to pay reduced rent so long as Borders did not occupy the shopping center. The landlord contended that the lease must be read to forbid Ann Taylor from continuing to pay reduced rent upon the replacement of Borders with another retailer.

The district court agreed with Ann Taylor finding that the co-tenancy unambiguously provided that Ann Taylor was permitted to pay abated rent under two conditions: (a) where Borders is not open and operating or (b) where 50 percent of the remaining retail space is not open and operating. The court further found that Borders could not be replaced by another tenant under section (a) because only the two specifically named major retailers were replaceable and the lease was silent about Borders, and that under section (b) Borders is specifically listed to mean that Borders, Inc., must be operating. In addition, even though the lease separately provided that the landlord does not warrant that any particular tenant will remain at the center, there was no conflict with the co-tenancy that provided for abated rent if the particular tenant vacated the property.

Therefore, the landlord was stuck with the abated rent because Borders went out of business.

LEASES—TAX PAYMENTS

The United States District Court for the Northern District of Illinois granted summary judgment in favor of the tenant because the landlord sought a proportionate share of taxes that included taxes paid by another tenant rather than directly by the landlord. *Payless ShoeSource, Inc. v. Dimucci Development Corp. of Cicero II*, No. 12 C 4159, 2013 WL 6069425 (N.D. Ill. Nov. 18, 2013).

Payless entered into a lease with Dimucci Development Corporation where Payless rented 4,000 square feet of space in the Cicero marketplace shopping center in Cicero, IL. In addition to rent, the lease also required Payless to pay a proportionate share of Dimucci's expenses, including real estate taxes.

Under § 7.02 of the lease, Payless was obligated to pay taxes in a proportionate share, which consisted of the space it leased divided by the gross leasable area of the shopping center (approximately 10.59 percent) and limited by a tax cap defined in the lease.

Payless paid the taxes under protest because it believed that Dimucci overcharged on the proportionate share of the taxes. Payless then filed the lawsuit, alleging that Dimucci overcharged for the pass-through expense. Dimucci claimed that it actually undercharged because it did not include the amount paid by another tenant, which paid 100 percent of the taxes on its portion instead of a proportionate share, and sought reimbursement for those taxes.

Relying on § 7.02 of the lease, Dimucci argued that Payless was required to pay its proportionate share based on the amount of space Payless leased divided by the shopping center's gross amount of floor space, regardless that another tenant paid all the taxes for all of the floor space it leased.

Based on the unambiguous provisions of the lease, the district court found that Payless was required to pay only for a proportionate share for taxes "paid by Landlord." Therefore, the taxes paid by the other tenant did not entitle the landlord to reimbursement because they were not paid by the landlord. In addition, the court found that the landlord's interpretation would be absurd:

> Were the Court to construe the Lease as Dimucci suggests, Dimucci would receive reimbursement from Payless for Taxes for which [the other tenant] had already reimbursed Dimucci. It is unfathomable that a reasonable party would enter into an agreement under which it would be required to reimburse another for costs for which the other party had already been reimbursed.

RECIPROCAL EASEMENTS

In overruling the trial court, the Indiana Court of Appeals ruled that one of the two adjoining business owners that held reciprocal easements for access to their establishments off the public highway cannot later grant use of easements to a nearby shopping center without the other's consent. *Pizza King of Elwood v. The Peniel Group, et al.*, No. 48A02-1302-PL-148, 2013 WL 6198240 (Ind. Ct. App. Nov. 27, 2013).

Easements are interpreted narrowly for the limited purpose that they are granted. A couple bought a bowling alley and the neighboring pizza restaurant. When they later divorced in 2003, the ex-wife became the owner of the pizza restaurant and the ex-husband became the owner of the bowling alley. In the deed for the bowling alley, the ex-wife conveyed "an easement for ingress and egress purposes over and along" the pizza restaurant portion of the drive.

The other side of the drive contained a strip mall. In 2004, the ex-husband signed a written agreement giving Elmwood Plaza—the owner of the strip mall—an easement along the entire drive, including the pizza restaurant's easement, for its own use. In exchange, Elmwood Plaza gave the ex-husband an easement for the bowling alley along a path that is part of the strip mall.

In 2005, Elwood Plaza sold the strip mall to Elmwood Holdings, which then enlarged the strip mall; a Dollar General store moved in, directly across the drive from the ex-wife's pizza restaurant's front entrance. Dollar General began using the pizza restaurant's easement, blocking access by the customers of the pizza restaurant and bowling alley. As a result, the ex-wife's pizza restaurant filed a complaint to prevent Elmwood Holdings and Dollar General's use of the easement, and to recover damages.

After a bench trial, the trial court determined that because the ex-wife granted the ex-husband the pizza restaurant's easement without explicitly restricting the ex-husband's ability to give it to others, his grant to Elmwood Holdings was valid. The trial court found that although the easement was valid for ingress and egress, the defendants were responsible for part of its upkeep and ordered the defendants to pay damages and to stop parking in the easement.

The Indiana court of appeals disagreed and found the grant of the easement to Elmwood Holdings to be invalid, holding that easements are limited to the purpose for which they are granted. The court found that an easement for ingress and egress confers only the right to pass over the land rather than conferring the more extensive right to partially control or alter the estate.

In interpreting the 2003 deed that granted the easement to the ex-husband, the court recognized that the deed conveyed "an easement for ingress and egress purposes only over and along" the portion of the drive owned by the pizza restaurant. The court found, based on the language that the intent was to give the ex-husband the bowling alley and a way to reach the bowling alley by passing the pizza restaurant.

The court of appeals concluded: "Because of the easement's limited purpose, [the ex-husband] did not have the authority to extend its use to Elmwood Holdings. Doing so clearly subjected [the pizza restaurant] to extra burdens."

SHOPPING CENTER DEVELOPMENT—SHAM LITIGATION

The fourth circuit court of appeals reversed the United States District Court for the District of Maryland and reinstated the lawsuit of a developer of a Gambrills shopping center to pursue its $25 million lawsuit against a union for using alleged "sham litigation" to attempt to keep the non-union supermarket chain Wegmans out of a shopping center. *Waugh Chapel South, LLC v. United Food and Commercial Workers Union Local 27*, 728 F.3d 354 (4th Cir. 2013).

The developer of commercial real estate to be used for a non-union supermarket filed suit against local unions and a labor management fund, alleging that they had orchestrated and filed 14 sham lawsuits and administrative challenges to force the developer to terminate their relation with Wegmans, in violation of the *Labor Management Relations Act* ("LMRA"). The United States district court for the district of Maryland granted the defendant unions and fund's motion to dismiss because (1) the *Noerr-Pennington* doctrine protected their First Amendment right to petition the courts and insulated their litigation activity from liability, and (2) the fund was not a labor organization under the NLRA.

The fourth U.S. circuit court of appeals agreed with the district court that the fund was not a "labor organization" under the NLRA, but concluded that the *Noerr-Pennington* doctrine, at the motion-to-dismiss stage, did not bar the claim. The court stated: "Although the courts are a medium by which citizens may exercise their First Amendment right to petition their government, the act of petitioning those courts may not serve as the means to achieve illegal ends." The court therefore held that under the "sham litigation" exception to the *Noerr-Pennington* doctrine, the pleadings and evidence, if credited by a factfinder, would be sufficient to show that the unions abused their right to petition the courts beyond the point of constitutional protection.

When the purported sham litigation encompasses a series of legal proceeding rather than a singular legal action, the court of appeals found that the trial court should conduct a holistic evaluation on whether "the administrative and judicial processes have been abused." The fourth circuit court of appeals concluded:

> There remains a genuine issue of material fact as to whether the pattern of litigation alleged in [the] complaint derived from "a policy of starting legal proceedings without regard to the merits and for the purpose of" waging a secondary boycott. In light of the poor litigation record and the signs of bad-faith petitioning, a factfinder could reasonably conclude that the unions have abused their right to petition the courts and, as a result, have forfeited the protection of the First Amendment.

As a result of the reversal reinstating the developer's claim against the unions, on November 8, 2013, the parties entered a stipulation of dismissal, presumably because of a settlement, and dismissed with prejudice the claims asserted by the developer against the unions.

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Attornment and Non-Disturbance Agreements

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Introduction

The general landscape of Canadian commercial leasing law tends to intersect with Canadian commercial mortgage law only briefly. In Canada, the extent to which the commercial leasing lawyer specialist deals with issues related to commercial mortgage law is usually confined to the "Subordination, Non-Disturbance and Attornment" provisions of a lease. Furthermore, for the landlord and the tenant, attornment is never the main event when negotiating those lease terms. To the extent that Canadian commercial leasing lawyers turn their minds to commercial mortgage law issues, they tend to focus primarily on the non-disturbance aspect of the discussion.

However, because Canadian property law allows tenancies to survive the enforcement of certain mortgage remedies, attornment is actually often of greater concern to a lender than subordination. And since the *quid pro quo* of a tenant's covenant to attorn is usually the promise of non-disturbance, Canadian commercial mortgage lenders should appreciate the significance of attornment when considering whether to give non-disturbance assurances to a tenant (or to tenants generally).

In this context, questions arise:

1. Is it sufficient for a mortgagee to rely on a lease term requiring the tenant to attorn to the mortgagee, or must the mortgagee have a separate attornment agreement directly with the tenant?
2. Are there any traps that a lender should be mindful of when entering into a non-disturbance agreement?

We will begin with a few short paragraphs that provide a brief background on the state of these issues in the Canadian context.

What Is Attornment?

Attornment is a legal device "akin to assignment."[1] If A owes a sum of money to B and B requests that A pay the money to C and A assents, A is said to have "attorned" to C; C may sue A for the debt.[2] So much has been written since *Goodyear Canada Inc. v. Burnhamthorpe Square Inc.*[3] ("*Goodyear*"), by so many thoughtful and articulate analysts,[4] that there is really nothing left to say about the basic premise of this now well-known area of law in Canada. When the mortgagor/landlord defaults on its mortgage, a mortgagee that enforces its remedies by realizing on the mortgaged property may seek to enjoy the benefit of tenancies created after the mortgage ("subsequent tenancies," or "subordinate tenancies").

In some cases, it may be necessary to ask tenants to attorn to the mortgagee as the landlord (i.e., to accept the mortgagee as the new landlord, by paying rent to the mortgagee and performing the obligations of the tenant in favour of the mortgagee *qua* landlord). But, as *Goodyear* highlighted and the subsequent literature has well explained: (1) a mortgagee may encounter difficulty when trying to enforce a promise to attorn that is given to the prior landlord under the lease; (2) a tenant may not be willing to attorn without assurances that its lease will be preserved exactly as written; and (3) in the absence of a separate NDA ("Non-Disturbance Agreement"), the tenant and mortgagee may find themselves in a different landlord-tenant relationship from what they expected, when the tenant does pay rent to the mortgagee *qua* landlord. Those who desire a more thorough explanation of the foregoing concepts should refer to numerous articles.[4]

What Is Subordination?

A lease may be entered into after a mortgage has been granted, in which case it is subordinate to the mortgage. Alternatively, the lease may be established, and later a mortgage granted, in which case the mortgage is subordinate to the lease.

In Ontario, if the lease or the mortgage (or both) is registered on title, the ranking of one over the other will be determined by the date of registration.[5]

In a lease, a tenant may agree to "subordinate" its lease to any mortgage. Where there is already a mortgage in place, this clause in the lease should be academic, as the mere fact that the mortgage was entered into before the lease should result in the lease being subordinate to the mortgage (barring a re-ordering of priority via title registration). However, if the landlord arranges new financing after the lease is in place, it may call on its tenant to take steps to confirm the subordination of the lease to the mortgage.

What Is Non-Disturbance?

Upon default under the mortgage, the mortgagee may realize on its security by foreclosing the equity of redemption held by the mortgagor. If the land is encumbered by a lease that is subordinate to the mortgage, the mortgagee may foreclose this subordinate interest as well; the mortgagee may realize on the entirety of the security that was pledged to it by the mortgagor. An NDA is an agreement between the mortgagee and tenant to ensure that this does not happen. An NDA will state that in the event of foreclosure, the mortgagee will not foreclose the lease held by the tenant. NDAs may also include specific provisions ensuring that terms of the lease that are important to the tenant will withstand any subsequent foreclosure (a common example is the right to renew the lease). The main purpose of the NDA is to ensure that if the mortgaged property changes hands through the enforcement of the mortgagee, the tenant will not be deprived of the lease that it bargained for.

Can a Mortgagee Enforce a Lease Clause Requiring a Tenant to Attorn to the Mortgagee?

Most of the literature seems to recognize the value of carefully drafted lease clauses regarding a tenant's obligation to subordinate and attorn, but fails to question whether the lease is the appropriate forum in which to make these commitments. It seems to be common industry practice to consider appropriately drafted subordination and attornment clauses as sufficient security to lenders, but there is Canadian case law that should cause commercial mortgage lenders to think again.

In *Goodyear*, as part of a letter agreement amending a lease, the landlord and the tenant covenanted to obtain "consents and non-disturbance agreements."[6] After negotiation, leases were signed, but consents and NDAs were never obtained. When the mortgagee foreclosed on the property, the tenant argued that there was no privity of contract between it and the mortgagee, and therefore the mortgagee did not have the right to enforce the provisions of the lease. The Ontario Court of Appeal agreed, holding that, absent an attornment agreement, a mortgagee has no grounds to compel a tenant to fulfill obligations under a subordinate lease.

The mortgagee argued all angles, submitting that the lease was preserved through privity of estate, an implied contract evidenced by conduct and/or assignment of rents, but none of these arguments was able to save the lease. After foreclosure, but before the matter reached the court, when the tenant was paying rent to the mortgagee, a new tenancy was created. The court held that the new tenancy had a yearly period term, terminable on each anniversary of its commencement, with at least six months' notice. The tenant lawfully terminated, and the mortgagee could not insist on the tenant fulfilling the balance of the lease obligations following the termination date.

PRIVITY

It is well-established law that the only parties who may enforce a contract are those persons who exchange mutual promises therein.[7] Since the 19th century, "consideration was thought of as the price of the promise and . . . only one who paid the price could enforce the promise."[8] Those who derived benefit from a contract, but offered no consideration in exchange, were seen as "stranger[s]"[9] to the contract who lacked the requisite privity and were therefore unable to sue for the performance of contractual obligations.

But the doctrine of privity is not without exception. In Canada, agency and trust law have adapted to permit third-party beneficiaries to enforce contracts that were intended for their benefit.[10] Similarly, progressive interpretation of the law regarding assignment has been applied to arrive at desirable results where the rule against third- party beneficiaries would do injustice.[11] In *London Drugs v. Kuehne*,[12] the Supreme Court of Canada canvassed the history of the doctrine of privity and the calls by law commissions and academics for its abolition. Short of overruling the doctrine, the court recognized an exception in the circumstances in order to conform to "commercial reality and justice."[13] In 1999, the Supreme Court of Canada recognized another exception in *Frasier River Pile & Dredge v. Can-Dive*.[14] While the doctrine of privity is still good law in Canada, these cases may suggest a trend away from privity of contract as a strict prerequisite to enforcement of contractual obligations.

Nevertheless, in *Lavalin Services Inc. v. National Life Assurance Co. of Canada*[15] ("*Lavalin*"), the Alberta Court of Appeal held that the mortgagee could not enforce the clause in the lease whereby the tenant promised to attorn. The lease provided that the tenant would "attorn to a mortgagee on demand by the mortgagee."[16] When the mortgagee requested the tenant to attorn, the tenant refused. The mortgagee then brought an application to declare the existence of the lease, presenting many of the same arguments raised in *Goodyear*. On the matter of enforceability of the attornment clause, the court of appeal held that it was not enforceable by the mortgagee because there was no privity of contract between the parties. One wonders, if this judgment was given today, whether the modern trend of permitting enforcement of contracts by third-party beneficiaries would have changed the outcome.

In the case of *DeGasperis Muzzo Corp. v. 951865 Ontario Inc.*[17] ("*Degasperis*"), the Ontario Court of Appeal treated the subordination clause in the lease as a binding obligation on the tenant in favour of the mortgagee. However, this holding should be approached with caution. Not only does it concern a covenant to subordinate (rather than to attorn), but also the subordination was effected through registration on title. The central issue of the case was whether the mortgagee's actual notice of the lease determined the priorities as between these parties, despite the registry. So while the subordination clause in the lease seemed to bind the tenant, the enforcement of such a clause was not an issue; the tenant had already registered as subordinate. Although some have commented that the case provides support for the proposition that a mortgagee can likewise rely on a tenant's covenant in a lease to attorn, there is nothing in the case that explicitly states so.

However, in *Vancouver City and Savings Credit Union v. Miller Electronic Ltd.*,[18] the British Columbia Court of Appeal implied that a mortgagee might be able to rely on an attornment provision within a lease, although there was no discussion of privity and the court ultimately found that the lease did not bind the mortgagee and the tenant. The court held that a condition precedent for the attornment provision had not been met, implying that, had the condition precedent been fulfilled, the lease clause would have been sufficient to bind the tenant and the mortgagee.

Generally, the case law in Canada is not reliable to establish that agreements between tenants and landlords are enforceable by mortgagees. Although an NDA will give a tenant comfort that its investment will be preserved despite a failed mortgage, there is the benefit to the mortgagee to consider. An attornment provision is a basic term of an NDA, and a mortgagee would be well advised to enter into an NDA if it intends to enjoy the benefit of a tenancy that is subordinate to the mortgage.

In *473807 Ontario Ltd. v. TDL Group Ltd.*[19] ("*Tim Hortons*"), the Ontario Court of Appeal held that the NDA established privity of contract between the tenant and the mortgagee. This ruling comes as no surprise. The case concerned the tenant's right to set off rents against the mortgagee *qua* landlord, in respect of amounts owed to the tenant by the prior landlord. Unfortunately, the case did not address whether such a result would have been found, had the tenant's commitments to the mortgagee been made solely through lease clauses. As a result of its devastating effect on the mortgagee in that case, it would be understandable if a mortgagee were to prefer not to sign an NDA, lest it face a similar fate.

Is It Good for a Mortgage Lender to Grant NDAs? Are There Traps for the Unwary?

Some Canadian lenders have begun including mortgage terms requiring the borrower/mortgagor to deliver an NDA (containing a covenant to attorn) in respect of every subsequent tenancy over a certain threshold (based on area). Some landlords have begun including lease terms that purport to give a mortgagee the flexibility to rank behind the lease.

While mortgagees would like to enjoy the greatest of flexibility with the greatest of benefit, the commercial reality is that a lender may not be able to have it all. Determining whether the benefits derived from the tenant's covenant to attorn outweigh the obligations undertaken when giving assurances of non-disturbance must be carefully analyzed in each case. To agree to provide NDAs to any tenant that asks for one is likely an overly ambitious commitment that may not pay off in the long run. To only provide NDAs when requested, however, leaves a lender in the risky position where it may find out, too late, that a valuable subordinate tenancy may not be preserved due to the insufficiency of a covenant to attorn located solely in the lease.

If only it were as simple as this: "Tenant covenants to attorn. Mortgagee covenants not to disturb" (followed by two signature lines).

In the real world, NDAs are typically far more vexing than that. For example:

1. **Tenant Seeks More Than Simply Covenant 'Not to Disturb'**
   A tenant may insist that the mortgagee not only covenant not to disturb, but that it covenant to *be bound by* the lease. (It will not alarm you to know that a mortgagee may not be keen to embrace an obligation to pay a lease inducement, or in some circumstances, even to perform a repair. For example, the lender in the *Tim Hortons* case was certainly not happy to observe the tenant's right to set off amounts owed by the former landlord against the rents due to the mortgagee.)
2. **NDA and Subsequent Amendments to the Lease**
   The mortgagee may not be willing to grant blanket non-disturbance that applies notwithstanding subsequent amendments to the lease. The mortgagee may insist that amendments be subject to its approval. These consent provisions have a tendency to be overlooked, and lenders may not have any incentive to consent when they are asked.
3. **Remedying Default of Prior Landlord**
   A mortgagee may not be willing to remedy defaults of the borrower landlord. If the default is "ancient," this might be an acceptable position, but if the default is either fresh or of an ongoing nature, a tenant may not be content to pay rent to the mortgagee *qua* landlord where the default on the part of the landlord is material.
4. **Restricting Exercise of Termination Rights**
   A mortgagee may not be willing to allow a tenant (that, after all, has covenanted to attorn) to exercise a termination right within the lease without the lender's consent. The mortgagee may seek to prevent a tenant from negotiating a surrender with the landlord, without the lender's consent.

Conclusion

A commercial mortgage lender likely counts on tenants' rents to pay the debt, to generate value for the property and to support a liquidation (if necessary). While a mortgagee may not be thrilled to offer an NDA in respect of a subordinate tenancy, and the terms of that NDA may be challenging, it is beyond noteworthy that by achieving such a relationship with a tenant—especially a key one—it will gain the benefit of certainty in knowing that the lease will be preserved. If it is a fair statement to say that mortgagors are more likely to fail in a "down-market," and if it is also more likely that tenants will seek to avoid attorning where their leases are "over-market," it may be a better bet for a mortgagee to lock in the subordinate tenant with a direct covenant to attorn, rather than to persist in holding the right to disturb.

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[1] S.M. Waddams, *The Law of Contract*, 6th ed. (Toronto: Canada Law Book Inc, 2010) at 201.
[2] *Ibid.* at p. 201.
[3] *Goodyear Canada Inc. v. Burnhamthorpe Square Inc.* (1998) 166 DLR (4th) 625, 41 OR (3d) 321 (ONCA).
[4] See, generally, Kenneth A. Beallor, "Subordination and Attornment" in Shopping Centre Leases (2nd ed., Canada Law Book) 2008; Brian Bucknall, "*Goodyear Canada Inc. v. Burnhamthorpe Square Inc.*: New Life in Old Law" (1999) 22 Advoc Q 117 1999-2000; Marilyn G. Lee, "Case Comment on *Goodyear Canada Inc. v. Burmhanthorpe Square Inc.*" (1999) Real Property Reports (3rd series), 21 RPR-ART 28; David B. Light, "The *Goodyear* Problem and Possible Solutions for Mortgagees" (2001) Canadian Bankruptcy Reports (4th series), 21 CBR-ART 148.
[5] *Land Titles Act*, RSO 1990, c L5, s 78(5).
[6] *Supra* note 3 at para 9.
[7] *Supra* note 1 at 197.
[8] *Supra* note 1 at 197.
[9] *Tweddle v. Atkinson* (1861), 1 B & S 393, 121 ER 762, rejecting *Dutton v. Poole* (1678), 2 Lev 210, 83 ER 523.
[10] *Supra* note 1 at 200-02.
[11] *Supra* note 1 at 198.
[12] (1992), 97 DLR (4th) 261 (SCC).
[13] *Ibid.* at 301.
[14] (1999) 176 DLR (4th) 257, [1999] 3 SCR 108.
[15] (1984), 42 Alta LR (2d) 28, 70 AR 358 (ABCA).
[16] *Ibid.* at para 3.
[17] (2000) 35 RPR (3d) 243 (OSCJ), affirmed in *DeGasperis Muzzo Corp v. 951865 Ontario Inc.* (2001) 42 RPR (3d) 63 (ONCA).
[18] (1987) 13 BCLR (2d) 205, 4 ACWS (3d) 434 (BCCA).
[19] (2006) 47 RPR (4th) 1, 271 DLR (4th) 636 (ONCA).

Be Careful What You Warrant For: What You Don't Know Can Hurt You

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A recent decision by the British Columbia Court of Appeal highlights the need to ensure that contractual warranties are carefully drafted and given adequate consideration. The vendor in this case was held liable for breach of warranty in relation to material facts it had not disclosed, despite having no knowledge of those material facts.

Background

In *0759594 B.C. Ltd. v. 568295 British Columbia Ltd.*, the purchaser bought 60 acres of land, with the intention of developing the property as a retail development with a big-box department store and also as a high-density residential development. The vendor's Property Documents stated that there was "approval in principle" for the rezoning.

The purchase contract contained the following warranty:

> Full Disclosure. So far as the Vendor is aware, the Vendor has disclosed to the Purchaser all material information pertaining to the Purchased Lands, whether solicited by the Purchaser or not. *Neither this Agreement nor any other document referred to in this Agreement* or any Schedule to this Agreement nor any statement, schedule or certificate furnished or to be furnished to the Purchaser pursuant to this Agreement *contains or will contain any untrue statement or omits or will omit to state a material fact. All material information pertaining to the Purchased Lands is set out in this Agreement or contained in the Property Documents*. [emphasis added]

Following the close of the transaction, the purchaser learned that roughly one-third of the property could not be developed due to riparian issues. The purchaser was unable to obtain zoning for its proposed high-density residential development on the remaining land. The purchaser also ran into strong local opposition to the big-box store.

The purchaser sued the vendor in misrepresentation, and later added a claim for breach of warranty. The court found that the vendor did not know about the issues complained of by the purchaser. As such, the misrepresentation claim fell by the wayside and the focus became the breach of warranty claim. In interpreting the warranty clause, the trial judge stated that it would be extraordinary for a vendor to assume the risk of unknown material information, and interpreted the warranty accordingly. As such, the trial judge found the vendor not liable because it was not aware of the material facts.

Appeal Decision

The court of appeal overturned the decision and held the vendor liable to the purchaser. The court interpreted the warranty clause as having two parts. The first part was qualified by the phrase "[s]o far as the Vendor is aware." However, the second part (the substance of which was emphasized in italics in the above-quoted language) was not. As such, the court held the warranty clause to require the vendor to disclose truthfully all material facts about the property, without any qualification as to the vendor's knowledge.

The court acknowledged that finding a vendor liable for matters outside its knowledge could lead to a harsh result. However, the court noted that the purpose of a warranty is to allocate risk, and referenced one of its recent decisions where a party was held liable for a defectively designed product because it had warranted that there would be no defects due to design, even though the design defects were due to improper specifications that were provided by the other party.

Implications

This decision emphasizes that commercial parties will be held to their bargains and can be held liable for matters outside of their knowledge. Representations and warranties inserted into agreements must be thoughtfully drafted. Where qualifications are to be made, the drafter cannot assume that a qualification in one section or sentence will impact the rest of the document. Unless the agreement is ambiguous, courts may interpret warranty provisions literally, even if it may lead to a seemingly unfair result.

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