RESIDENTIAL

California Supreme Court to Review Conflicting Decisions

Calling into Question When the Purchaser at a Foreclosure Sale Can Start its Eviction

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It is understandable that a purchaser of a property at a trustee's sale is anxious to immediately begin eviction proceedings in order to take possession of and market the property. However, two recent published decisions draw into question the practice of serving the properties' occupants with a Notice to Quit *before* perfecting title. Supreme Court review is needed to resolve the issue and provide guidance to purchasers.

As more fully discussed in this article, after the Appeals Division of the Superior Court in *McLitus* ruled that both sale and title to be perfected prior to even service of the Notice to Quit, the Court of Appeals in *Westlake* clarified that California *Code of Civil Procedure* § 1161a held that title must be perfected prior to the tenant being removed from the property, not prior to service of the Notice to Quit.

In *U.S. Financial, L.P. v. McLitus*, 6 Cal. App. 5th Supp. 1, 2016 Cal. App. LEXIS 1057 (Cal. Super. Ct. 2016), U.S. Financial purchased the subject property at a trustee's sale held pursuant to *Civil Code* § 2924. As many foreclosure purchasers do, it immediately served a Notice to Quit prior to recording the Trustee's Deed Upon Sale with the County Recorder's Office. Upon expiration of the Notice to Quit, U.S. Financial filed a post-foreclosure unlawful detainer action under *CCP* § 1161a against Michael McLitus, the former owner and occupant of the property. McLitus argued U.S. Financial had failed to perfect title to the property prior to serving the Notice to Quit and thus had failed to meet the prerequisites of bringing an unlawful detainer action under *CCP* § 1161a. The Trial Court entered judgment in favor of U.S. Financial stating that it had perfected the sale and title upon recording the Trustee's Deed with the County Recorder. McLitus appealed.

The Appellate Division of the Superior Court found that although U.S. Financial perfected the sale it had **failed to timely perfect** title prior to serving the Notice to Quit. The Appellate Division explained that perfecting the sale and title are two separate and distinct requirements and in order for a purchaser to avail itself to the rights and privileges of summary unlawful detainer proceedings the sale and title must first be duly perfected.

The Appellate Court in Dr. *Leevil, LLC v. Westlake Health Care Center*, (2017) 2017 Cal. App. LEXIS 192, did not agree with the Appellate Division's interpretation of the

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requirements of *Code of Civil Procedure* § 1161a and distinguished the ruling of the *McLitus* Court. Under a similar post-foreclosure fact pattern the Appellate Court in *Westlake* clarified that "[t]he statute [California *Code of Civil Procedure* § 1161a] does not require that title be perfected (i.e., that the trustee's deed be recorded) before service of the three-day notice. It requires that title be perfected before a tenant 'may be removed' from the property." *Westlake* at *7. The Appellate Court further explained that adding the requirement that title be perfected prior to service of the Notice to Quit would impose an extra obligation that *Code of Civil Procedure* § 1161a does not demand, which the courts are not permitted to do.

In late June, the California Supreme Court agreed to review *Dr. Leevil* decision. Its decision should decide the issue once and for all, providing purchasers with a clear path to eviction. Until then, purchasers at foreclosure sales would be well advised to take immediate steps to perfect the sale and title after a trustee's sale. If bringing an eviction action on other grounds, speak to an attorney to ensure all prerequisites are met prior to serving an eviction notice.

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- A significant portion of lease agreements contain "frozen GAAP" or "semifrozen GAAP" clauses (the covenants are calculated based upon the accounting standards in affect at the time of the agreement).
- Bank outreach reveals an ongoing commitment to customers.
- Operating lease liabilities are operating obligations rather than debt.
- There's still time before the guidelines must be adopted.

PRESENTATION OF OPERATING AND FINANCE LEASES

To make it easier to identify the type and amount of lease obligations, liabilities capitalized from operating leases are to be shown separately from those of finance leases, either on the face of the balance sheet or in the notes to the financial statements. ASC Topic 842 also requires that lease liabilities be shown separately from other assets and liabilities either on the face of the balance sheet or in the notes to the financial statements. These new disclosure requirements will enable lenders to more easily identify the nature and extent of a borrower's contractual obligations and cash flows related to leases.

Similar to today's standard, ASC Topic 842 also requires lessees to disclose a maturity analysis of their lease obligations. Finance lease liabilities and operating lease liabilities (again, shown separately) should show the lease payments on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. Lessees must also disclose a reconciliation of the lease payments to the finance lease liabilities and operating lease liabilities recognized in the statement of financial position.

WORK AHEAD

Processes for credit underwriting and risk management can vary by institution. Some lenders often rely only on lease-related footnote disclosures to determine future contractual obligations or compliance with loan covenants while others may not incorporate lease obligations at all.

Lenders should consider taking steps today to inventory and understand the magnitude of the potential changes for lease liabilities, enabling them to be fully informed of the financial implications once leases are recorded on the balance sheet versus only in footnote disclosures. For example, does your institution's risk underwriting model distinguish between operating liabilities and debt? Lenders will also need to consider if changes in key ratios brought about by the new standard will impact their ability to underwrite certain loans.

Communication and training is essential for lenders to inform and train loan and credit analysts on the impact of the new requirements—including this loan covenant issue—so they're prepared to deal with changes in credit underwriting. Starting the discussion now will help both all parties avoid unwanted surprises or disruptions when the new rules are fully effective.