Los Angeles lawyers Maura B. O’Connor and Brett L. Hayes offer lenders a due diligence checklist for income-producing property.

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Maura B. O’Connor, a partner, and Brett L. Hayes, an associate, in the Los Angeles office of Holland & Knight LLP, specialize in commercial real estate financing, acquisitions, development, and leasing. In “Caveat Lender,” they discuss the intricacies of due diligence for lenders in tenant-occupied real property transactions. Their article begins on page 26.

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Are You Ready?

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Is the U.S. economy in a recession? If so, when will the recession end? When will the next recession arrive? Among real estate professionals, these questions are discussed often and with great passion. The answer, of course, depends on each person’s point of view, though most likely all will agree that the economy is in distress.

The real estate industry is a major driving force in the economy, so a recession not only adversely affects the industry but, conversely, the ills of the industry may be a contributing cause of a recession.

Of course, a recession is not necessarily a bad thing for all people in business. To the extent a poor economy forces distress sales of property, it affords an opportunity to initiate the age-old formula for success in the real estate industry—buy low. Owners can then wait for the economy to rebound to utilize the other half of the equation—sell high. Still, for those whose business is the operation of tenant-occupied property, a downturn in the economy is not welcomed if vacancies increase.

While the real estate industry is affected by national trends, it still remains primarily subject to local forces. For example, even in the midst of a troubled national economic climate, California voters recently passed a school improvement bond initiative that is expected to inject more than $1 billion into the local economy.

For lawyers who serve the real estate industry, whether or not the economy is in a recession turns on how their clients are surviving. Even though some practitioners and their clients may be fortunate enough to not be adversely affected by the current economic climate, practitioners should always temper their own as well as their clients’ optimism about the future with the need to plan for the worst. It is important for us as lawyers to understand the legal issues that affect our clients during good times as well as bad.

This month, in Los Angeles Lawyer’s 18th annual Real Estate Law issue, we have collected a variety of articles that touch upon a range of issues that will confront real estate practitioners, whether their clients are faced with a real estate boom, a bust, or something in-between.

Federal, state, and local governments continue to create new laws and regulations that lawyers need to monitor and analyze for their clients. The representation of clients in real estate matters has evolved into a multidisciplinary practice, and so the number of laws and regulations, both new and old, requiring the attention of real estate practitioners seems to grow by the day.

For example, environmental law has become an entire practice area with direct relevance to the real estate industry. One aspect of environmental law involves the past use of chemicals without concern for the environment, which may haunt owners and lenders involved with affected properties. Indeed, the fear of becoming entangled in remediation activities of uncertain cost and duration has led to many properties becoming unmarketable as well as unusable. The new law designed to stimulate the redevelopment of contaminated properties known as brownfields may not adequately address this fear.

Also, very few residential or commercial projects are built or purchased without some amount of third-party financing. Counsel to lenders and borrowers must be mindful of how loan documents address the relation-ship between the parties. Even though interest rates may be lowered as a stimulus to prospective borrowers, lenders may still tighten underwriting standards when faced with the potential of default and the prospect of devalued collateral. Thus, it is critical for lenders and borrowers to focus on the fundamentals of what makes for a strong project.

We hope you will enjoy reading the articles in this special issue. We thank Paul Marks and Dennis Perez, our colleagues on the Los Angeles Lawyer Editorial Board, for their editorial assistance.
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Refinancing Your Home Mortgage

As a result of falling interest rates, it may be possible to save money with a new loan

The Federal Reserve has cut its key lending rate a dozen times since January 2001. In a survey by Freddie Mac, the quasi-governmental purchaser of the home loans of many Americans, the median age of home loans refinanced in the first quarter of 2001 was only 1.6 years—the lowest it has been since Freddie Mac started tracking this figure. Additionally, refinancers generally have enjoyed an appreciation of their property in recent years, allowing them to take advantage of newfound equity.

If in 2001 you financed $250,000 for the purchase of a new home at the then-current fixed interest rate of 7.875 percent, your current mortgage payment is $1,813 per month. If you qualify at rates effective November 2002 (which may be as low as 6.125 percent), your monthly payment would be $1,494—a monthly savings of $319. If you put less than 20 percent down on your original purchase, your lender likely required private mortgage insurance (PMI) on the mortgage. If your refinanced mortgage is less than 80 percent of your home’s newly appraised value, you would not have to pay the PMI premiums of $50 or more per month.

Keep in mind, however, that while refinancing reduces the monthly mortgage payment, it also typically increases the term of the loan—which can dramatically increase the total cost of the loan. Since the largest interest charges occur at the start of the loan, and beginning a new loan means making those high interest payments all over again, if a borrower takes the full time to pay off the new loan, refinancing could easily cost more than keeping the current loan. But there are other reasons to exchange your current loan.

Perhaps you want to tap the equity that has built up in your home since your original purchase or last refinance. In that case, you could elect a “cash-out refi” by obtaining a new loan based on the home’s current appraised value, thereby allowing you to pay off what is owed on the old loan and eliminate any secondary financing or other outstanding debt, or reinvest the money in home improvements (potentially further increasing the home’s value).

Another reason to refinance might be to switch from an adjustable-rate mortgage (ARM), in which the loan’s interest rate changes based on market conditions, to a fixed-rate loan, which offers the certainty of set payment amounts no matter what happens to interest rates in the future. Alternatively, since ARMs often start at rates substantially lower than those charged for fixed-rate loans, you might want to switch from a fixed rate loan to an ARM (or different type of ARM) to take advantage of a particularly low introductory interest rate. The variety of different loan programs in this category has grown in the last few years so that even simply considering whether the loan should be adjustable or fixed, borrowers now have the option to choose from a number of hybrids in which they make fixed interest-only payments for a certain period of time, after which the interest rate floats (or adjusts) to the market interest rate. At that time the borrower makes a fully amortized payment of principal and interest for the remainder of the loan term.

Finally, you may want to build the equity in your home faster by shortening the term of the loan. You can do that by swapping your current 30-year mortgage for a 15- or 20-year loan. If interest rates have come down enough, you may even be able to achieve this change with only a marginal increase in your monthly mortgage payment. However, a disciplined borrower can achieve the same result by making additional principal payments on a 30-year mortgage (for example, a borrower who makes one additional mortgage payment per year can reduce a 30-year loan term by eight years), so financial planners caution borrowers not to commit too much money to their homes.

Rules of Thumb

At one time, the general rule was that it paid to refinance only when the new loan’s interest rate was two percentage points lower than the current loan’s. But with the variety of loan programs now available, that rule is now too simple. The term “no cost,” however, is something of a misnomer, because it does not mean that the refinance is free; it simply means that the borrower will not have to pay anything out of pocket at closing. The fees charged by the lender will either be added to the new loan’s principal or the interest rate will be somewhat higher.

To really compare apples to apples, you should compare the after-tax cost of the proposed loan with that of the current loan. Since mortgage interest is deductible from federal taxes, the after-tax cost of the loan equals the principal and interest payment after deducting the taxes saved by the deduction. Continuing the example in which a $250,000 loan (with a current balance of $245,942) is refinanced for a 30-year term at 6.125 percent, at a total cost of $2,000, the current monthly mortgage payment is about $1,813, of which about $1,615 is interest. That translates into an after-tax payment of about $1,360 (assuming the borrower is in the 28 percent tax bracket). The new loan’s monthly payment would be about $1,494, of which about $1,276 is interest, for an after-tax cost of about $1,136 and savings of about $224 per month. At the new interest rate, it will take about nine months before the bor-
rrower breaks even. Therefore, if the borrower plans to stay in the house longer than nine months, refinancing may make sense.

Refinancing does not always make sense, however. Some borrowers with second mortgages, a lot of debt, or trouble paying bills on time might discover that they would pay more by refinancing than they will by sticking with the loan that they already have. Such borrowers may also not want to put their house at risk by consolidating unsecured debt into a larger secured mortgage. Alternatively, such a borrower may be able to obtain a home equity line of credit (HELOC), which depending on current interest rates could be at an interest rate lower than that of first mortgages—as is the case now. For borrowers who do not require much money and do not intend to have the loan outstanding for long, the no-cost lure of a HELOC can be persuasive. With a HELOC the borrower pays interest-only payments only when the line is accessed and then only on the monies that are actually borrowed. Principal is payable upon maturity—which typically occurs after 10 years. This type of loan permits borrowers to tap their equity when it is necessary without having to go through the lengthy and time-consuming process of obtaining yet another mortgage loan.

As soon as you have made the decision that you want to refinance, your first step should be to make certain that you have a clear picture of your financial situation—in much the same way that you prepared in obtaining your current loan. Review and understand the terms of your current loan, analyze your current financial situation, and obtain, review, and correct any discrepancies or problems on your credit reports.

**Where to Start**

Your current lender knows your payment history and is familiar with the property. You would think that it would be easier for your current lender to refinance your existing loan, at a better price than what a third-party lender could offer, since it is easier to keep a good customer than it is to find a new one. In some cases when the borrower is not seeking cash-out refinancing, the current lender may even be able to modify the existing loan by reducing the interest rate, without refinancing the existing loan. However, the majority of loans are packaged with other loans and sold to third-party investors, with the result that the existing loan is not able to be modified. Many lenders, however, can offer streamlined refinancing in which the appraisal can be obtained electronically, the title search is abbreviated, and other items and documentation that would normally be required on a new loan are omitted.

If you are looking elsewhere, consider your credit union; local savings and loan; community bank; local, regional, or national mortgage company; and even a commercial brokerage bank. Under the Real Estate Settlement Procedures Act, within three days after the loan application has been submitted, the amount of fees and charges that are to be paid in connection with the loan will be provided on the Good Faith Estimate. The estimate sets forth the annual percentage rate for the loan, which is the total charges calculated on an annual basis and stated as a percentage, including not only the interest rate but also such one-time loan fees as discount points that increase your overall costs. While the Good Faith Estimate is not perfect—in that it assumes that the loan will continue until maturity—it is an invaluable tool for the borrower to use in comparing proposed new loans. Practically everyone these days is in the home loan field, and there is a plethora of good lenders and mortgage brokers to choose from, but it will always pay to confirm for yourself the loan programs, interest rates, and terms available to you.
The New Markets Tax Credit Program

New tax credits will level the playing field for investments in low-income areas

Unleashing the untapped economic potential of low-income communities and marshalling their financial resources to revitalize impoverished urban and rural areas are the ambitious goals of a new federal tax credit program—New Markets Tax Credit (NMTC)—now being implemented by the U.S. Treasury Department. The NMTC program is intended to stimulate $15 billion in investments in economically distressed communities through the allocation and purchase of special tax credits.

The NMTC program is also intended to dispel certain long-held perceptions about low-income communities. One is that poor communities are risky areas in which to do business. Another is that low-income people cannot afford to pay for anything beyond the bare essentials of life. Several studies suggest the opposite, that low-income communities are ripe for new businesses and investments. A national study on impoverished urban areas reveals:

- More than $85 billion in annual retail spending—7 percent of all U.S. retail spending—comes from these areas.
- Approximately one-quarter of this demand, or $21 billion, is not being met by neighborhood retailers.
- Retail demand per inner city square mile is often two-to-six times greater than in each metropolitan-area square mile.

A report undertaken for and released by the Institute for Public Policy at Pepperdine University reaches much the same conclusion for the local South-Central Los Angeles area: “Compared with the rest of L.A. County, we find that South L.A., per capita, has 65 percent fewer grocery stores, 40 percent fewer banks and other financial institutions, and 20 percent fewer clothing stores. Most residents shop outside the area because many of the retail goods and services offered within the neighborhoods do not adequately meet the type of goods in demand. This is particularly true in the case of retail grocery goods....In a previous RLA study conducted in 1995, residents in one targeted South L.A. area spent roughly $1 billion in retail grocery goods. However, it was estimated that approximately $412 million of this was spent outside the targeted market area.”

It is the purpose of the NMTC to reconcile the needs of low-income communities with the financial requirements of retailers, developers, and investors.

Under the NMTC program, investors may claim a 39 percent credit over seven years (30 percent in present value) on their federal income tax liability for qualified investments. The credits will be apportioned at 5 percent per year for the first three years and 6 percent for each of the remaining four years. These investments must be made in for-profit organizations established to do business in low-income communities. By early 2003, $2.5 billion in NMTCs will be allocated—$1 billion in credits carried over from 2001 and $1.5 billion in the 2002 statutory allocation. The remaining $12.5 billion will be allocated over the next several years, ending in 2007.

NMTCs are designed to di-
rect investment capital solely to “low-income communities” and “low-income persons.”

Under the Internal Revenue Code, a low-income community is one or more census tracts in which the poverty rate for each tract is at least 20 percent, or, for metropolitan areas, the median income does not exceed 80 percent of the greater of the statewide median income or the metropolitan-area median income. Similarly, a low-income person is, for persons living in metropolitan areas, an individual whose income does not exceed the greater of 80 percent of the statewide median family income or 80 percent of the metropolitan-area median family income. Adjustments are made for an individual’s income based on family size.

The Community Development Financial Institutions (CDFI) Fund in the Treasury Department manages the NMTC program. Congress created the CDFI in 1994 to expand the availability of credit, investment capital, and financial services in distressed urban and rural communities. The CDFI is responsible for certifying the organizations entitled to receive NMTC allocations and has established a competitive process for making the actual tax credit allocations to these organizations.

Both the Community Renewal Tax Credit Relief Act and the NMTC program were enacted as part of the appropriations bill for the Labor, Health and Human Services and Education Departments for fiscal year 2001. The NMTC and other legislative programs in the act represented a true bipartisan effort between the White House and Capitol Hill.

Community Development Entities

Community Development Entities, or CDEs, play a pivotal role in the NMTC program. With certain qualifications, CDEs are the only entities that may apply for NMTCs. CDEs are also the only entities that can receive an allocation of these tax credits and direct how the proceeds from the sale of these credits to investors will be used. Any legal entity duly organized and validly existing under the laws of the state in which it is incorporated or established may qualify for CDE status. This includes a for-profit corporation or subsidiary of one, a nonprofit corporation or its affiliate, a partnership, or a limited liability company.

Because the claimed NMTC is based on the amount of an investment—such as the purchase of stock or a capital interest in a partnership—only CDEs that are for-profit entities may actually receive an allocation of NMTCs. Consequently, nonprofit organizations involved in community development must form for-profit affiliates to receive tax credit allocations.

Regardless of the legal form, no organization may represent that it is a CDE until it has been certified by the CDFI. CDE certification requires passing two tests: the “primary mission” test and the “community accountability” test.

The primary mission of the entity must be to promote community development. The entity’s organizational documents (e.g., articles of incorporation, bylaws, annual reports) must clearly show that its purpose is to serve the needs of, or provide investment capital for, low-income communities or low-income persons. In addition, at least 60 percent of the products and services of the entity must be devoted to serving these communities or persons, such as investments in or loans to businesses or persons in these areas or financial support to organizations that promote community development.

The entity must also be accountable to the residents of its “service area.” A service area may include a neighborhood, city, multiple cities, a state, a multistate area such as Appalachia, or even the nation as a whole. Accountability is satisfied by representation: At least 20 percent of the governing board of the entity or an advisory committee formed by the entity must include representatives of low-income communities within the service area. While the CDFI encourages CDE applicants to include low-income persons on the board or committee, this requirement may also be satisfied, for example, by representation from a business owner from these communities or a board member or staff person from an organization serving the area.

CDE certification is valid for 15 years unless revoked or terminated by the CDFI. A CDE must certify annually to the CDFI that it meets the primary-mission and service-area requirements. By August 2002, the CDFI had certified 544 CDEs and, based on pending applications, the total could eventually exceed 1,000. Many applications are from nonprofit organizations seeking certification of for-profit entities. Local CDEs certified by the CDFI include the California Community Reinvestment Corporation, Community Commerce Bank, Century Community Development, Inc., Los Angeles Community Resources Financial Center, and the Inglewood Neighborhood Housing Services, Inc.

Century Community Development, Inc., an affiliate of Century Housing Corporation, intends to apply for an NMTC allocation. Century Housing is the successor nonprofit organization to a program established by the consent decree in Keith v. Volpe. Since 1979, Century Housing has met its judicial mandate of replacing low-income housing displaced by the Century Freeway by financing and/or developing 9,500 affordable units throughout Los Angeles. Century Community Development envisions using the proceeds received from investors to finance mixed development projects. These projects could comprise affordable housing financed with low-income housing tax credits and commercial projects backed by the sale of NMTCs. The proceeds may also be used to support nonprofit service providers, such as child care and educational organizations.

The CDFI issued a Notice of Allocation Availability in June 2002 and set August 29, 2002, as the deadline for submission of allocation applications. By that date, the CDFI had received more than 1,000 applications. The CDFI is expected to announce its allocation decisions in early 2003.

Once the CDEI deems an applicant eligible and its application complete, the application is evaluated according to four criteria, each with a maximum of 25 points. There are also two bonus criteria worth an additional five points each. The CDFI has indicated that the following is required for an applicant to score well:

- Business investment strategy. A CDE must show that it will make loans or investments that meet the needs of underserved markets, are flexible or nontraditional, and are focused on customers who lack access to conventional sources of capital. A CDE also has to show a track record of investing in low-income communities and a readily identifiable set of business activities in which it will be involved between the allocation date and December 31, 2003, and a strategy for identifying other potential transactions in the future. A CDE must also describe the extent to which the entity will invest in unrelated businesses.

- Capitalization strategy. A CDE must demonstrate that it has secured commitments from investors or has a reasonable strategy of obtaining such commitments. The CDFI must also show that its NMTC allocation request matches the level of investments that it expects to raise and the loans and equity that it will disburse. Consistent with one of the key reasons for enactment of the NMTC, a CDE has to show that it can leverage other sources of funding in addition to the cash that it will receive from NMTC investors. Finally, the CDE must indicate if it will invest the proceeds from investors that exceed the requirements of the “substantially all” test (described below).

- Management capacity. The CDFI will evaluate the experience of the CDE’s management and staff in investing in low-income communities, raising capital (especially from for-profit investors), asset and risk manage-
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ment, and its history of complying with other federal programs, such as the program for low-income housing tax credits.

- **Community impact.** The CDFI will look at the involvement, if any, of low-income community representatives in the development and implementation of the CDE’s investment strategy; the current activities of the CDE in these communities; the extent to which the CDE’s investment strategy is consistent with federal, state and local development plans; the economic results that could not be achieved without NMTCs; and why those results could not be duplicated or enhanced through other sources.

The CDFI will also award up to five points to CDEs that satisfy each of two bonus criteria established by statute. The first criterion is a record by the CDE itself or an organization controlling the CDE of successfully providing capital or technical assistance to disadvantaged businesses and communities. The other five bonus points will be awarded to CDEs that demonstrate that they will make investments in businesses in which persons unrelated to the CDE hold a majority equity interest.

The 2002 applications were initially reviewed and scored by three outside reviewers. CDFI staff are now evaluating the applications, and the CDFI will award allocations to the most qualified CDEs. The CDFI has not made any determination on the maximum amount of NMTCs that may be allocated to a given CDE. However, it is anticipated that the maximum allocation to a single CDE will not exceed $100 million.

If a CDE receives an NMTC allocation, an allocation agreement will be entered into between the CDE and the CDFI. The terms and conditions of the agreement will include the amount of NMTCs allocated to the CDE, the approved uses of the allocation (e.g., loans or equity investments to qualified businesses or to other CDEs), the service areas in which the NMTC proceeds may be disbursed, the deadlines by when the CDE must have received investments, and reporting requirements. Nonprofit organizations that receive an allocation must also satisfy the CDFI that they control the for-profit subsidiary that will actually receive the NMTCs and that the nonprofit intends to transfer the allocation to that subsidiary.

**Qualified Low-Income Community Investments**

Once the agreement is in place, a CDE may exchange its NMTCs for Qualified Equity Investments (QEI). A QEI may take the form of a purchase of stock (if the CDE is a corporation) or a capital interest (if the CDE is a partnership or limited liability company).
A CDE may receive only one form of consideration for a QEI—cash. 17

An important feature of the NMTC program is the flexibility it affords a CDE in using its cash proceeds and structuring the terms and conditions of its investment in low-income communities. Any investment that meets the legal requirements of a Qualified Low-Income Community Investment is acceptable. A QLICI can take several forms.

One form is an equity investment in, or loan to, a Qualified Active Low-Income Community Business.18 A QALICB is any corporation or partnership in which 1) at least 50 percent of the total gross income of the business comes from the active conduct of a qualified business in a low-income community, 2) at least 40 percent of the tangible property that the business owns or leases is located within a low-income community, and 3) at least 40 percent of its employees' services are performed in a low-income community.

Determining if a business meets the 50 percent gross income test is difficult if a business has offices, plants, and distribution centers both inside and outside low-income communities or if the business conducts some of its transactions, for example, over the Internet. In these situations, the IRS has indicated the requirement will be met if 50 percent of the business's tangible property is located within a low-income community or if 50 percent of the services it performs is by employees in a low-income community.19

The term “qualified business” also requires definition. Generally, a QALICB may engage in any trade or business with certain exclusions. Those exclusions include the rental of residential property or businesses that consist predominantly of the development or holding of intangibles; the operation of golf courses, country clubs, massage parlors, hot tub or tanning facilities; racetracks or other gambling facilities; liquor stores; or farming.20

Other types of QLICIs include:

- An investment in, or loan to, another CDE,21 in which the recipient CDE makes loans to a QALICB or provides financial counseling or other services to businesses in or residents of low-income communities.
- The purchase of a loan (but not investments) from another CDE if the loan is a QLICI.22
- Providing financial counseling and other services (i.e., advice on organizing or operating a business) to businesses located in, and residents of, a low-income community.23

Regardless of what form the QLICI takes, the CDE must ensure that the investment meets the “substantially all” test, which may be met in one of two ways. The first is that at least 85 percent of the taxpayer's investment

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Mr. Gleitman has practiced sophisticated estate planning for 24 years, specializing for more than 12 years in offshore asset protection planning. He has had and continues to receive many referrals from major law firms and the Big Four. He has submitted 36 estate planning issues to the IRS for private letter ruling requests; the IRS has granted him favorable rulings on all 36 requests. Twenty-three of those rulings were on sophisticated asset protection planning strategies.

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must be directly traceable to a QLICI. This percentage is calculated by taking the aggregate cost basis in all QLICIs that are directly traceable to the taxpayer's cash investment and dividing it by the total amount of the taxpayer's investment. The other way to meet this test is through the "safe harbor" calculation, under which at least 85 percent of the aggregate gross assets of the CDE must be invested in QLICIs. This percentage is calculated by taking the CDE's aggregate cost basis in all its QLICIs and dividing it by the CDE's aggregate cost basis in all its assets.

This test must be met annually during the entire seven-year compliance period, and the test must be performed every six months. If a CDE makes loans and receives repayment of principal or equity, the substantially-all test will be considered to be met if the loan principal repayments are reinvested by the end of the next calendar year or equity payments are reinvested within 12 months. Repayments of loan principal or equity received within the last year of the seven-year credit period do not have to be reinvested. This is also true for interest or dividend payments. Under the NMTC rules, up to 5 percent of the cash received for an investment may be held for loan loss reserves, and these proceeds can also be applied towards meeting the substantially-all test.

As with any provision in the IRC, there are many other rules that govern the conduct of a CDE and investors in these transactions. For example, a CDE must allocate its entire share of NMTCs within five years of the date of its allocation agreement. A CDE must also disburse within one year the cash it receives from an investor in exchange for an NMTC allocation. For investors, NMTCs may only be claimed in an amount equal to the actual investment in the CDE and not the amount used by the CDE from the investment proceeds to buy a project or provide financial assistance to a business. Also, the investor's basis is reduced by the NMTCs allocated to the investor.

A CDE may use the 15 percent of its investment that is not dedicated to meeting the substantially-all test for other purposes, including broker fees, underwriter fees, issuance expenses, or cash reserves.

New Markets Tax Credit Deals

Investors may choose, as they already do under the low-income housing tax credit program, to invest directly in a CDE receiving an NMTC allocation or make their investment through funds that will purchase NMTCs from CDEs that have received allocations. Commercial banks may therefore become a significant investment source. KeyBank, for example, is marketing itself as a "one stop
shop” for investments using NMTCs. To accomplish this, the bank qualified several related entities as CDEs and applied for an NMTC allocation of $250 million. The bank has also formed several funds with an investment banking firm through which investor proceeds will be used to make mezzanine loans to QALICBs and purchase federal historic tax credits.

To illustrate how NMTCs could fit within a loan package offered by a bank like KeyBank, consider a QALICB needing $10 million for a commercial development. The bank would make a conventional loan of $7.5 million and a mezzanine loan of $750,000 (30 percent of $2.5 million). The mezzanine loan would be financed by cash that a KeyBank-affiliated CDE receives from the purchase of its NMTC allocation. Because of the tax savings realized by these investors from the NMTCs, the bank could charge the QALICB a lower interest rate on the mezzanine loan. An economic investor such as a high net-worth individual would then finance the balance. Although the QALICB would pay a higher interest rate to this investor, its overall debt service payments would be less because of the lower rate charged on the mezzanine loan.

The treasury secretary is authorized to issue regulations limiting “the credit for investments which are directly or indirectly subsidized by other Federal tax benefits.”30 One subsidy specifically referenced was the low-income housing tax credit. However, in September 2002, the IRS issued a notice indicating that it would not apply limitations to historic rehabilitation tax credits, depreciation deductions, and tax benefits allocated to empowerment zones and enterprise communities.31 The IRS also said that it is continuing to review the limitation between NMTCs and low-income housing tax credits. For CDEs and investors, this notice is significant. It means, for example, that financing for a commercial development involving the restoration of a historic property could be eligible for both NMTCs and historic tax credits.

Apart from the risks perceived in investing in low-income communities, investors must also take into consideration the actual risk that NMTCs can be subject to recapture for seven years after an equity investment is made. Recapture may occur if 1) a CDE ceases to meet the CDFI’s certification requirements, 2) the CDE fails to continuously use substantially all of a qualified equity investment, 3) the CDE redeems the qualified equity investment, or 4) the IRS finds that the principal purpose of a transaction is inconsistent with the purpose of the NMTC program.32 Bankruptcy of a CDE does not con-
In 2003, $4 billion in NMTCs will be allocated by the CDFI—$2.5 billion at the beginning of the year from the 2001 and 2002 allocations and eventually $1.5 billion from this year’s allocation. In 2004 and 2005, $2.5 billion more will be allocated each year, followed by $3 billion in both 2006 and 2007. If any credits remain unused after 2007, Congress has provided that the CDFI can allocate them until 2014.

The amount of NMTCs actually allocated by the CDFI will not determine the success or failure of this tax credit program; rather, its immediate future rests in the response of investors. A CDE’s receipt of a NMTC allocation does not guarantee that investors will purchase stock or a capital interest in that CDE. Investors are expected to weigh many factors before deciding to make an investment. A significant factor will be whether or not the rate of return measures up to the risks associated with the CDE’s proposed use of the investor’s cash and if those risks will be mitigated through diversified investments. Other considerations will be the track record of the CDE or its sponsor, the qualifications of its management, and the procedures created by the CDE to ensure ongoing compliance with the requirements of the NMTC program. Investors will also take a hard look at the strategy proposed by the CDE for the investor to exit the entity after the seventh year and receive a return of its capital.

Investors will also look to maximize the tax benefits of NMTCs, especially if the IRS permits these credits to be leveraged. Leveraging is already an essential part of the NMTC program because CDEs are expected to build on the capital raised from the sale of NMTCs to attract other financing sources for investments.

Leveraging can also make NMTCs more attractive to investors. In a simple, straightforward NMTC transaction, an investor only receives tax credits based on the amount of cash that it pays for its investment in a CDE. By contrast, as an example of a leveraged transaction, an investment partnership could be formed in which the investor puts its money into the partnership and a bank makes a loan to the partnership and not the CDE. The investment partnership would invest the total proceeds received from the investor and the bank into a CDE. The investor would then receive NMTCs based on the total amount of the partnership’s investment and not just its own funds. In this case, the rate of return to an investor could rise dramatically.
While these and other issues will need to be resolved, there are many reasons to be optimistic about investor response to the NMTC program. First, CDEs that succeed in the application process and receive allocations will most likely be those that developed programs in which investors have committed to buy NMTCs or expressed a strong interest in doing so.

The experience of the Low-Income Housing Tax Credit program also provides a basis for optimism. When the LIHTC was created by the Tax Reform Act of 1986, many dismissed the notion that investors would be willing to purchase tax credits generated from the construction or rehabilitation of affordable housing. The IRS, investors, and housing developers also had to resolve many issues presented by the statute creating the LIHTC program. Sixteen years later, these issues have been largely resolved, the LIHTC is a permanent tax credit, and investors have demonstrated their confidence in the program by purchasing billions in credits.

Some observers believe the NMTC program is even more attractive than the low-income housing program. The NMTC program has a shorter compliance period—7 years, compared to 15 years for LIHTCs. Another is that the exact stream of financial benefits can be calculated more readily; the flow of benefits is not dependent on when a building becomes occupied. Other perceived advantages include the absence of foreclosure risks and a reduced chance of tax credits being recaptured in a NMTC transaction.

Over the next seven years, the NMTC program will be successful if investors recognize that their investments are creating new business ventures that will tap the considerable economic potential of low-income communities and the people who reside in them. By doing so, the tax credits will not only provide these communities with needed jobs and services but also will eventually lead to their revitalization.

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4 I.R.C. §45D(a).
5 I.R.C. §45D(a)(2).
6 I.R.C. §45D(e).
10 I.R.C. §45D(b).
11 Keith v. Volpe, No. 72-355-HP (C.D. Cal. filed July 7, 1972). Under a consent decree, the Century Freeway Housing Program was mandated to replenish affordable housing stock depleted during construction of the Century Freeway.
13 Id. at 40117-18.
14 I.R.C. §45D(d)(2).
16 I.R.C. §45D(b)(6).
18 Treas. Reg. §1.45D-1T(d)(1)(i).
19 Treas. Reg. §1.45D-1T(d)(1)(ii).
20 Treas. Reg. §1.45D-1T(d)(1)(iii).
21 Treas. Reg. §1.45D-1T(d)(1)(iv).
22 Treas. Reg. §1.45D-1T(d)(1)(v).
23 I.R.C. §45D(h).
24 I.R.C. §45D(i)(1).
25 I.R.C. §45D(i)(2).
26 I.R.C. §45D(c).
27 I.R.C. §45D(a)(1).
28 I.R.C. §45D(a)(2).
29 I.R.C. §45D(b)(6).
30 I.R.C. §40016 (June 11, 2002).
31 I.R.C. §45D(b)(6).
33 I.R.C. §45D(b)(1).
Civil Code Section
3110.5 creates
uncertainty for
owners, lenders,
and contractors

California Civil Code Section 3110.5, which became effective January 1, 2002, was passed into law with little or no fanfare and apparently caught many practitioners off guard. Among its provisions, the statute requires that the owner of an interest in real property provide security for the owner's payment obligations under a construction contract for certain works of improvement. It also provides the original (or prime) contractor with the right to suspend work on the contract if the security is not furnished.

The legislative history of Section 3110.5 makes it clear that the statute’s proponents were responding to the injustice inherent in prior case law that required an original contractor to pay its subcontractors even if the original contractor itself had not been paid. The legislators intended to provide contractors with sufficient leverage to induce owners to make progress payments promptly. Moreover, the statute declares that contractual waiver of its benefits is against public policy. Thus the importance of understanding the requirements and ambiguities of Section 3110.5 cannot be overstated.

The obligations of Section 3110.5 apply to owners of interests in real property that enter into construction contracts with original contractors for works of improvement on the property. An owner of an interest in real property includes the fee simple absolute owner as well as owners of lesser interests in the property, such as a lessee or an easement holder.

Certain property owners are exempt from the requirements of Section 3110.5. These include:

1) A qualified publicly traded company, or a wholly owned subsidiary of a qualified publicly traded company (provided that the qualified publicly traded parent guarantees the obligations of the subsidiary under the construction contract).

2) A qualified privately traded company, or a wholly owned subsidiary of a qualified privately traded company (provided that the qualified privately traded parent guarantees the obligations of the subsidiary under the construction contract).

In order to be exempt, a publicly traded company must have nonsubordinated debt of at least investment grade quality, while a privately traded company must have a minimum net worth of not less than $50 million as determined in accordance with generally accepted accounting principles. An exempt owner who ceases to qualify for an exemption at any time prior to final payment on a construction contract otherwise subject to Section 3110.5 will, upon losing the exemption, be obligated to provide the security required by the statute.

Owners involved in large development deals may have assets sufficient to satisfy the net worth criteria. However, owners seeking to engage in smaller transactions may find themselves saddled with a new and unanticipated cost that may render the deals economically unsound or impractical. Although the security required by the statute is intended to be composed of a portion of the contract price, the interplay between the statute's requirements and the methods by which construction projects are typically financed will likely result in the owner at best incurring costs of making the security available in the manner required by statute and at worst being obligated to make the security available in addition to the entire contract price.

Further, while large companies themselves may be exempt from the requirements of the statute, the involvement of an exempt company as a partner or member holding less than 100 percent of the ownership interests in a property owner will not extend the exemption to the property owner, which must independently meet the exemption criteria.

The statute’s requirements apply only to works of improvement that exceed certain minimum value thresholds. Section 3110.5 protections do not apply unless either the contracting owner has a fee simple interest in the property and the value of the contract exceeds $5 million, or the contracting owner holds some lesser interest in the property and the value of the contract exceeds $1 million. It is unclear whether owners will be able to avoid the applicability of the statute by contracting for works of improvement using multiple small contracts, thereby creating a situation in which no single contract meets the minimum threshold requirement. However, this mechanism could be challenged easily. First, even initial compliance with such a plan by an original contractor later could be characterized as an unenforceable waiver of the protections to which the contractor was entitled under the statute. Further, to the extent that these contracts were between the same owner and contractor and given that a “work of improvement” is defined as the entire scheme of improvements, courts would probably not have much difficulty characterizing groups of small contracts between an owner and a contractor as one contract for a single work of improvement.

Certain types of construction contracts are themselves exempt from the statute’s requirements. These exempt contracts are for the construction of:

1) Single-family residences, including those located within a subdivision or “any associated fixed works that require the services of a general engineering contractor.” A single-family residence is defined in Section 3110.5 as an “improvement used or
intended to be used as a dwelling unit for one family." 

2) Public works projects.

3) Housing developments eligible for a density bonus.

Section 3110.5 is clear in its exclusion of single-family residential projects. Less clear is whether apartment projects and condominium or townhouse projects that are intended as single-family residences but possess many of the characteristics of multifamily projects would be exempt from the statute as well.

**The Security Requirement**

If an owner enters into a contract that is subject to Section 3110.5, the owner is required to provide the original contractor with security for the owner’s payment obligations under the construction contract. The amount of the security should consist of at least 25 percent of the total amount of a construction contract providing for substantial completion within 6 months, or 15 percent of the total amount of any other construction contract. If the construction contract does not contain a fixed price, the amount of security must be based on a percentage of a guaranteed maximum price; if there is no guaranteed maximum price, the security amount is determined "with reference to" the contracting owner’s and original contractor’s good faith estimate of the contracting owner’s payment obligations under the construction contract.

If the valuation of a contract is uncertain, Section 3110.5 does not provide guidance for the parties in determining whether the statute applies. The statute provides for the use of a good faith estimate, if necessary, to ascertain the amount of the construction contract for the purpose of determining how much security should be provided. This mechanism, however, is not extended to the valuation of the contract for the purpose of determining whether the statutory obligations attach. Therefore, parties cannot avoid the statute by intentionally omitting a contract price and giving "good faith estimates" that the contract will be worth less than the minimum threshold requirements. On the other hand, the statute does not address what parties should do when there is genuine uncertainty about whether the contract exceeds the statute’s minimum value thresholds.

The contracting owner may provide the required security in one of three alternative forms: a payment bond, an escrow account, or a letter of credit that is issued by a financial institution.

For a payment bond to satisfy the requirements of Section 3110.5, it must be payable if the contracting owner has defaulted on an undisputed payment obligation under the contract and the obligation has been due and payable for more than 30 days. This option may be unattractive to some owners because bonds are increasingly less available and more expensive, and bonding companies are accustomed to dealing with and issuing bonds to contractors rather than owners.

In order to meet the security requirement with an escrow account, the contracting owner must establish the account before work commences under the construction contract with an initial deposit of an amount that is not less than the minimum required security. If the construction contract provides for retentions from progress payments, the retentions must be deposited into the escrow account as the progress payments are made. However, the outstanding balance of the escrow account at any given time need not exceed the total amount of remaining payments to the original contractor under the construction contract. While the funds in the escrow account remain the property of the contracting owner, they are subject to a first priority security interest in favor of the original contractor and are effectively unavailable to the owner until released.

Funds held in an escrow account may be disbursed only upon either the joint authorization of the owner and contractor or in accordance with a court order that is binding on both parties. The conditions for disbursement upon the joint authorization of the owner and contractor are subject to negotiation between the parties so long as the required minimum balance is maintained. Because the owner and the contractor can negotiate additional conditions to the disbursement of funds from a Section 3110.5 escrow account, a construction lender may be able to require the owner to add a condition of prior consent from the construction lender. It is unclear, however, whether courts will see this type of condition as an impermissible impediment to construction contract payments or will evaluate the requirement with recognition of the need of the contracting owner to obtain financing.

The provisions regarding escrow accounts almost certainly conflict with the customary construction loan draw procedures, which often provide that the construction loan funds do not belong to the borrower until the funds are advanced (at which point they will accrue interest). Alternatively, if the construction loan funds are deemed advanced at the origination of the construction loan, the funds would be subjected to a first priority security interest in favor of the construction lender. Moreover, under a typical construction loan, the lender will hold all retainages as additional collateral. Because Section 3110.5 expressly does not require a lender to deposit its funds into the escrow account, the borrower may have to fund the escrow with separate money, resulting in a significant duplication of certain funds required for a financed project. This would render many prospective transactions a practical impossibility for developers that need to borrow funds in the first place.

There are several criteria for using a letter of credit to fulfill the security requirement of Section 3110.5. The letter of credit 1) must be irrevocable, 2) must inure to the benefit of the original contractor, and 3) must be maintained in effect until the owner has satisfied all of its payment obligations to the original contractor. As long as these criteria are met, the maturity date and other terms of the letter of credit may be determined by the contracting owner, the original contractor, and the issuer of the letter of credit. Because contracting owners may have difficulty obtaining payment bonds, and because an escrow account ties up substantially more funds, the letter of credit may be the most attractive choice for owners, at least in financed projects. Although issuers of letters of credit increasingly require cash collateral—and this, like an escrow account, restricts available funds—the parties may find that construction financing can be structured to provide for a letter of credit when collateral has already been provided. However, even under this scenario, the lender that issues the letter of credit will likely include the amount of the letter of credit (whether or not drawn) in the financing and thereby reduce the net proceeds of the loan. As a result, the contracting owner may still find itself short of funds.

If the contracting owner fails to provide or maintain the security required by Section 3110.5, the original contractor may make a written demand on the owner. If the contracting owner fails to comply with the requirements of Section 3110.5 within 10 days of the contractor's demand, whether or not the owner has timely performed its payment obligations to date, the original contractor may suspend work until compliance occurs.

**Other Interested Parties**

Section 3110.5 as drafted also may confer benefits upon parties other than the original contractor. These include contractors other than the original contractor (for example, subcontractors) that have provided work at a particular property. Section 3110.5 explicitly provides that it does not affect other provisions in the Civil Code regarding mechanic's liens, stop notices, bond remedies, or prompt payment rights of subcontractors (including the payment responsibilities of the original contractor). Since any payment bond pro-
vided by the contracting owner must satisfy the requirements of Civil Code Section 3096, which contemplates a bond covering a range of claimants, the bond provided by the contracting owner under Section 3110.5 may be subject not only to the claims of the original contractor but also to the claims of others.

Further, under the Civil Code, a wide range of claimants may give stop notices to either the contracting owner or the construction lender. The Civil Code defines “construction lender” broadly to include “any escrow holder or other party holding any funds furnished or to be furnished by the owner or lender or any other person as a fund from which to pay construction costs.” This definition includes the issuers of Section 3110.5 letters of credit and the escrow agents of Section 3110.5 escrow accounts. Thus, any party entitled to issue a stop notice pertaining to a particular work of improvement could presumably enforce this right against an issuer of a Section 3110.5 letter of credit or the escrow agent of a Section 3110.5 escrow account.

Contractors and owners will not be the only parties grappling with the practical application of Section 3110.5. Indeed, construction lenders also will be interested in the requirements of the statute, particularly the extent to which they can obtain interests in Section 3110.5 security.

Construction lenders may want to be certain that they obtain from owners specific covenants to ensure that the parties are in compliance with Section 3110.5, including covenants regarding the present and continued exemption of the owner or construction contract from the statute’s requirements. This will create added pressure on the transaction, since neither the lender nor the owner will want to increase the project costs, but the lender will want the ability to act quickly to prevent the stoppage of work should that issue arise.

Construction lenders may also consider taking a security interest in Section 3110.5 escrow accounts or letters of credit. Section 3110.5 does not prohibit the granting of such a security interest but clearly contemplates that the contractor will have a first priority security interest in Section 3110.5 escrow accounts, and that letters of credit issued pursuant to the statute will be in favor of the original contractor. Further, Civil Code Section 3166 provides that an assignment of any construction loan funds by an owner or contractor will not have priority over the rights of a claimant giving a stop notice to a construction lender, whether the assignment was made before or after the stop notice was given. Since a stop notice could also be issued to an escrow agent or issuer of a letter
of credit holding Section 3110.5 security, the lien of a construction lender on the security would likely be junior to the rights of other stop notice claimants.

Practitioners should pay heed to Section 3110.5, which creates considerable uncertainty for owners, contractors, and lenders. At least initially, the statute presumably will result in a significant increase in project costs for all but the most substantial developers. And construction financiers may be less inclined to finance transactions that are subject to Section 3110.5 requirements.

4 Civ. Code §3110.5(a)(1). If there are multiple parties with interests in the same property, the obligations of §3110.5 fall only upon the owner contracting for the work of improvement. Thus the landlord whose tenant has contracted for a work of improvement has no obligation under §3110.5—although the tenant’s failure to comply with the statute may have detrimental consequences for the landlord whose tenant defaults and leaves behind a partially completed project.
5 Civ. Code §3110.5(f).
6 Id.
7 Id.
8 Id.
9 Civ. Code §3110.5(b)(1-3).
10 Civ. Code §3110.5(e).
11 Civ. Code §§3110.5(b)(1), 3096.
12 Civ. Code §3110.5(c).
13 “Financial institution” means a thrift institution, a commercial bank, or a trust company. Civ. Code §3110.5(b)(2); Fin. Code §5107.
14 The statute offers no guidance as to what is an “undisputed” payment and therefore on what basis the contractor may make a claim. However, since the type of payment bond that may be provided under Civil Code §3110.5 is the same form of bond to be provided by contractors and subcontractors under Civil Code §3096, it may be reasonable to infer that the dispute mechanisms applicable to §3096 bonds also are applicable to §3110.5 payment bonds. See Civ. Code §3110.5(b)(1).
15 Civ. Code §3110.5(b)(1).
16 In order to satisfy the requirements of §3110.5, the escrow account must be designated as a “construction security escrow account,” 2) maintained with a licensed or exempt escrow agent, and 3) located in California. Civ. Code §3110.5(b)(3)(A).
19 Civ. Code §3110.5(a).
20 Civ. Code §3110.5(b)(2).
21 Civ. Code §3110.5(b)(2).
22 Civ. Code §3110.5(c).
23 Civ. Code §3110.5(e).
24 Id.
25 Id.
26 Id.
27 Civ. Code §3110.5(d).
In today’s real estate market, time is the most priceless commodity. Clients, more than ever before, insist that their counsel close real estate transactions quickly and inexpensively. The result is that lawyers have less time to investigate the real property that drives these transactions. Under these circumstances, a due diligence review that misses a key fact might become a malpractice trap for the unwary lawyer.

This may be particularly true for lawyers who represent lenders financing real property loan transactions that involve tenants. When these lawyers undertake a due diligence review for their clients, they face unique problems that will be neglected unless the lawyers know what to look for during the review. The primary problem is the lender’s reluctance to foreclose on the real property. Most lenders are not equipped to manage rental properties, and the last thing any lender wants to do is spend more money on foreclosed property. Thus most lenders have a lower tolerance for risk than most landlords borrowing money. Lawyers should ensure that the lender’s due diligence review is expansive enough to determine:

1) The financial terms of the tenant leases. Lawyers should inquire whether there is sufficient cash flow to service any debt and create a profit.
2) The areas of the leases most likely to cause legal problems. Lenders should know about the risks of disputes that could interrupt the flow of rents—and how and if they can limit these risks.
3) The provisions that would apply to the lender as successor landlord if it were to foreclose upon the property.

When a lender’s due diligence review involves tenant leases, the lender’s lawyer should review each lease, together with all lease amendments, side letters, work letters covering construction of tenant improvements (commonly referred to as TIs), and any other documents outlining the obligations of the landlord and the tenant. This review should be done as early as possible in order to correct or address any problems in the leases before the transaction closes. The documentation for the planned transaction should include representations and warranties from the current owner/landlord and the tenants. The lender or its counsel should review all parts of each lease. Ideally, the lender should also receive confirmation from the borrower/landlord in the loan documents and from each tenant in the tenant estoppel certificates that there are no oral or written under-
standings between the landlord and any tenant other than those provided to the lender in
writing. (See “Tenant Estoppel Certificates,” this page.)

Basic Terms
The lawyer’s review of the existing leases should cover the basic terms of each lease: the name of the tenant, the space covered by the lease, the amount of the rent, and the method by which it is calculated. In a retail lease, it is important for lenders to learn whether percentage rent (usually based on retail sales) is paid. In an office lease, lenders need to know whether the tenant must pay any other charges, such as utilities; taxes; common area maintenance (CAM) charges; heating, ventilation and air conditioning (HVAC) services during business hours or on weekends; or part of the cost for any TIs. The lawyer also typically evaluates the credit enhancements for each tenant—including lease guaranties, letters of credit, or other mechanisms that secure the tenant’s obligations—to determine if there are alternative sources of recovery for the lender if the tenant defaults.

The due diligence review should clearly identify the circumstances that allow tenants to terminate their leases. Usually lenders want leases to state that a tenant can terminate its lease only if a casualty or condemnation destroys most or all of the leased premises and the damage will not be repaired for a significant period of time. Most leases also should provide that a tenant cannot terminate its lease for reasons beyond the landlord’s control. For example, a shopping center tenant should not be able to terminate its lease due to the failure of an anchor tenant to operate during required mall operating hours because the anchor tenant has filed for bankruptcy protection. The lawyer should check the insurance provisions of the leases as well to determine whether they are compatible with the casualty and condemnation provisions of the leases.

The due diligence review should also reveal whether TI allowances are provided. TI allowances are sums of money that are sometimes provided by a landlord to a tenant for the tenant’s use in “building out” the tenant’s premises. The use of TI allowance funds should generally be restricted to items that increase the value of the building. If TI allowances may be used for “soft” costs (such as architect’s fees and permit costs), the dollar amount that can be used for these costs should be specifically stated in the lease. The amount of (or formula used to calculate) any TI allowance should be clearly stated, especially in leases for premises in which construction of the tenant’s improvements is not yet complete and in future leases. When the TI allowance is based on the square footage of the premises, the lease should specify whether the reference to square footage is to total or usable square footage and should state which one of the standard methods of measuring these types of square footage was used. These methods include those of the Building Owners and Managers Association (BOMA) or the American Industrial Real Estate Association (AIR).

Ideally, counsel should review all agreements concerning brokers’ commissions for all leases that are involved in the property. Before a loan is made, lender’s counsel should make sure that all commissions that are due before the closing of the loan have been paid for the leases in effect. Because some commissions may have a structured payoff over a number of years, lawyers for lenders should analyze whether the payment of any future leasing commissions will adversely affect cash flow and the borrower’s ability to repay the loan. In addition, the lender needs to know whether additional commissions are due if tenants expand their premises or extend the terms of their leases. Since a lender will assume the obligations of the borrower following foreclosure, a lender’s lawyer should determine whether, if foreclosure were to occur, the lender would be liable for the broker’s commissions.

Valuation and Cash Flow
Once a lender’s lawyer has determined all the charges that the tenants are required to pay under their leases, and all the expenses that the landlord must bear (including unpaid TIs and commissions and all concessions to the tenants), the lender’s principals or underwriters can use the information to estimate the value of the property based upon the capitalization of the actual net income generated by the property. A lender usually will want its underwriters to determine whether the net cash flow from the property is sufficient for the borrower to make all payments in a timely fashion. The estimated value for the property should be compared to the appraised value of the property. If a great discrepancy

Tenant Estoppel Certificates
A due diligence review by a lawyer for a lender client regarding a loan secured by real property with tenants should ensure that the lender is aware of all aspects of the tenants’ leases and other agreements. The lender should secure a representation by each tenant, in the form of a tenant estoppel certificate, of the specific details of the tenant’s lease, and the lender should be able to rely on the certificate when closing the transaction and in the event of any disputes. The statements in the certificate should confirm, at a minimum, all of the following:

- A true and correct copy of the lease and all amendments, side letters, and any other agreements modifying the lease are attached, and the amended lease is in full force and effect.
- The tenant has accepted the premises and is currently occupying them and paying rent and any other charges (such as operating costs and CAM costs). The certificate should contain the amount of the rent and the other charges.
- The actual commencement date of the lease.
- The square footage of the premises.
- The amount of any security deposit paid to the landlord by the tenant.
- The tenant has not paid any amounts to the landlord other than rent and the security deposit.
- The landlord has not defaulted under the lease, and the tenant knows of no action or omission that, with the giving of notice or the passage of time, or both, would become a default by the landlord.
- The tenant has no claims or defenses to enforcement of the lease, nor any right to any offsets against rent. Or, if the tenant has any such claims, defenses, or rights, the tenant must specifically list them.—M.B.O. & B.L.H.
exists, a lender may wish to reconsider the validity of its appraisal and the amount it is willing to lend.

To determine whether the income stream derived from the leases will support the repayment of the loan, a prudent lender will estimate the cash flow from the tenants’ rent—net of all expenses—while applying a reasonable vacancy factor to account for occasional tenant attrition. This cash flow estimate should include an analysis of what would happen if certain contingencies allowed by the leases were to take place—for example, if a tenant were to exercise its option to purchase its premises or to buy out its lease for a predetermined termination fee. The estimate also may include the effect of any credit enhancements provided by the tenants. Determining the value of the property and the cash flow are usually tasks that are assumed by lenders because of their own unique underwriting requirements. Nevertheless, a savvy lender’s lawyer should be intimately familiar with the lender’s underwriting process in order to better advise a lender on actual versus improbable risks.

A thorough due diligence review will also disclose whether tenants have any right to self-help in the resolution of problems with the landlord. The lease, for example, may allow a tenant to set off rent against the costs of repairs or similar costs. Self-help rights have become extremely prevalent in retail leases involving anchor tenants or other sophisticated tenants, and these rights can impede cash flow in a variety of unpredictable ways. If a lender’s due diligence discloses these rights, then the lender could craft a resolution with the borrower precluding the enforcement of these remedies against the lender after a foreclosure.

The review also should disclose whether an original tenant is automatically released from liability for payment under its lease if it assigns its lease to a third party. Most lenders object to such a provision because they want as many creditworthy parties on the hook as possible.

Another important issue is whether the leases are structured so that inflation is not likely to diminish their profitability. Some leases provide that rents may increase by a set amount over time, or that rents may be adjusted by the increase in the Consumer Price Index or some similar formula. Some leases adjust the rents to estimated market rates by means of dueling appraisals or through arbitration. A careful lawyer will also check to make sure that CAM costs and other operating costs that the tenant is required to pay are adjusted for inflation.

If one or two large tenants are involved in the property, the lender needs to consider whether the cash flow from the property will be severely diminished if those key tenants leave. If anchor tenants have the right to terminate their leases upon payment of a fee or by exercising an option to purchase the property, the size of the fee or purchase price should be considered. In addition, some lenders require that all lease termination fees be paid directly to them instead of to the borrower/landlord. If a tenant has an option to purchase the property, most lenders will insist that the option price be equal to at least the unpaid balance of the mortgage (plus any senior liens) at the time of purchase, and that the mortgage be paid in full when the option price is paid. Again, the familiarity of lawyers with their lender clients’ underwriting requirements will help the lawyers identify these economic concerns and advise their clients about them earlier rather than later in the transaction.

**Exclusive Use Clauses**

As part of the due diligence analysis, lenders’ lawyers should be aware of any exclusive use clauses in tenants’ leases. Tenants with these clauses could have conflicting rights. From a lender’s perspective, exclusive use clauses can be troublesome because they limit lease activity, increase the likelihood that a tenant may terminate the lease, and potentially limit the lender’s ability to lease space to competing tenants in other nearby properties owned by the lender.

The pitfalls associated with exclusive use clauses are boundless. Therefore, a lender’s lawyer should be intimately familiar with all exclusive use provisions and should correct any shortcomings in the clauses prior to the close of any loan transaction.

Lenders’ lawyers must assess whether the exclusive use clause is “business-oriented” or “product-oriented.” A narrowly drawn business-oriented exclusive use clause is limited in scope and does little to restrain competition between tenants. For example, if an exclusive use clause has been granted to a tenant to operate an office supply store, tenants operating a computer store or business furniture store in the same shopping center would not violate the first tenant’s exclusive use clause.

Alternatively, a product-oriented exclusive use clause curbs competition because it specifically identifies products that other tenants cannot sell. The problem with product-oriented exclusives is that they place a significant burden on landlords to continuously supervise and monitor their tenants. For example, in a California case involving a drug store, the landlord promised its drug store tenant that no other store would be permitted to sell drugs, medicines, or cosmetics in the shopping center. A supermarket tenant subsequently began to sell these types of products. The landlord argued that it relied on the supermarket to work out its differences with the drug store tenant. But the court held that the landlord could not avoid its obligation under the lease by seeking to delegate its performance to others.

Ideally, the lawyer’s review of the leases should be used as a base from which to obtain tenant estoppel certificates, which are detailed representations about the leases typically prepared by buyer’s or lender’s counsel for review and execution by each of the tenants of a property. A certificate should expressly provide that in closing the contemplated transaction, the buyer or lender and its counsel will rely on the statements in the certificate. If a tenant signs such an estoppel, it cannot later
take a different position about facts it has affirmed in its signed certificate.

**Foreclosure Issues**

While lawyers need to conduct their due diligence review against the backdrop of knowing that lenders seek to avoid foreclosure, lawyers still must evaluate whether the leases of the property at issue would be acceptable to the lender if the lender were to foreclose on the property and step into the shoes of the landlord.

Typically, a lender’s lawyer will analyze the financial terms of the leases with the lender, considering which agreements of the original landlord would be so burdensome to the lender after a foreclosure that the lender would not be willing to be bound to them. Some of the types of agreements that might be overly burdensome include:

- An agreement by the landlord to provide or finance a TI allowance to the tenant or to build TIs for any expansion space.
- An agreement allowing a tenant to use the premises without paying rent during certain periods. (These periods usually occur early in the term of the lease, but agreements sometimes provide for rent-free periods at other times during the term.)
- An agreement by a landlord to pay the obligations of its tenant under the lease at a different location (usually the tenant’s former premises).

The object of this review is to identify obligations that the lender is not willing to assume, so that the lender’s counsel can draft appropriate Subordination, Nondisturbance and Attornment agreements (SNDAs) in which the lender is absolved from liability for those obligations if it forecloses.2

A key question that the lender’s lawyer will need to answer in advance is whether the leases will survive a foreclosure. The black letter law of real estate priorities is “first in time, first in right,” meaning that a mortgage (or deed of trust) recorded in the public records after the recordation of a notice or memorandum of lease is junior in priority to the lease. If a memorandum or notice of a lease is recorded after a mortgage is recorded, the lease is generally junior to the mortgage. Many leases contain subordination clauses that may not work to a lender’s advantage. Automatic subordination clauses are provisions that make the tenant’s lease automatically junior to any lender’s mortgage. Such provisions can be dangerous for lenders to accept, because they are often too broadly drafted. For example, such a clause can make a tenant’s lease junior in priority, or subordinate, to all mortgages, including junior financing. From the senior lender’s position, this could lead to an unpleasant situation in which
a junior lender that forecloses its mortgage could extinguish leases that the senior lender would prefer to keep in place. For these reasons, any lender that accepts an automatic subordination clause in leases should make sure that the clause operates only to subordinate the lease to its own mortgage.

With each important tenant, it is prudent to enter into an SNDA that provides contractually that the tenant’s lease will remain effective after a foreclosure by the lender. Without an SNDA, it can be difficult to predict whether, after a foreclosure, the lender or other purchaser of the foreclosed property will be entitled to enforce the leases.

Typically, if a mortgage junior to a lease is foreclosed, the lease remains in effect and the purchaser at the foreclosure sale (usually the foreclosing lender) takes title to the property subject to the lease terms. If a mortgage senior to a lease is foreclosed, under California law the junior lease usually is terminated by the foreclosure, the tenant is no longer obligated under the lease, and the purchaser at foreclosure gets title to the property—but risks losing the tenants. In some states, however, including California, tenants in possession when the loan is made may have certain rights, even if their leases are not recorded and are therefore junior to the foreclosed mortgage, but the obligations of the purchaser as successor landlord may not be clear.3

In California, although case law is rather muddled and may result in unexpected consequences, the general rule is that a lease that is subordinate to a deed of trust is extinguished by foreclosure of the deed of trust.4 Since using an SNDA both creates a more predictable outcome and protects foreclosing lenders by ensuring that the existing leases will be enforced after a foreclosure even in a falling rental market, most lenders should use SNDAs to limit their risks.

If the review of a lease discloses major problems that are so severe that a carefully drafted tenant estoppel certificate alone will not fix them, the lender’s lawyer should recommend that the lender ask its borrower, the landlord, to resolve all those lease issues by use of either an SNDA or an amendment to the lease. The extent to which a lender can obtain the agreement of a tenant to resolve the ambiguities and problems caused by the lease depends upon the bargaining power of the lender, landlord, and tenant.

Alternatively, the lender and the tenant can agree, in an SNDA or in a separate contract, that certain obligations and promises of the original landlord will not be binding upon the lender if it forecloses on the property. Lenders’ lawyers may require representations and warranties from the borrower concerning the performance of its obligations as landlord, including the borrower’s confirmation that it is not in default in its obligations as landlord under the leases, and the borrower’s express promises to perform its obligations as landlord under the leases.

There is no magic to due diligence. It is, in many respects, a thankless job. Nevertheless, if done properly, the service provided to clients is invaluable, not to mention one that they genuinely appreciate in the end. Although time may be in short supply for real property transactions, conducting a sound and thorough due diligence review will help most lawyers sleep soundly through the night after their deals have closed. ■

Brownfields are properties whose redevelopment is hindered by the presence of contamination. Ostensibly passed to “promote the cleanup and reuse of brownfields,” the Brownfields Revitalization and Environmental Restoration Act of 2001 (BRERA), signed into law in 2002, is the latest set of amendments to the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA). However, analysis of the complex provisions of these amendments reveals little that will promote those ends. Instead, the amendments offer more sticks than carrots, create as many problems as they solve, and contain traps for the unwary.

This situation, unfortunately, is not new. CERCLA has been problematic for owners and purchasers of real estate ever since its passage in 1980 in response to national concern over sites such as the infamous Love Canal. CERCLA was intended to provide the legal tools to clean up contaminated sites. One of those tools is the imposition of strict, joint, and several liability for cleanup on current owners and operators of properties from which there is a release of hazardous substances, as well as persons who owned and operated a property at the time that any disposal of hazardous substances occurred. The list of hazardous substances is long, and liability is not dependent on the amount of hazardous substances released. Current owners are liable even if they had nothing to do with causing the contamination.

This draconian liability scheme has brought much financial pain to those who have bought industrial and commercial properties either before CERCLA’s passage or, afterwards, without due consideration for the problems they were purchasing. It has also resulted in many contaminated properties lying fallow because of the well-founded concern that their purchase could lead to liabilities that far exceed any economic value that might otherwise be derived from the property. The notion of providing incentives for the redevelopment of contaminated properties was entirely absent from CERCLA.

Recognition that this liability scheme was causing problems came fairly early, but the response was timid—the reform was so narrowly crafted as to be of dubious value. Specifically, the first set of amendments to CERCLA, passed in 1986, created what is now widely known as the innocent purchaser defense. In a typically obscure bit of CERCLA

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drafting, this defense was created by inserting a definition of “contractual relationship,” a term used in one of the three original defenses provided for in the original statute. To qualify as an innocent purchaser, a landowner had to prove satisfaction of six conditions: 1) the disposal of the hazardous substances occurred prior to acquisition, 2) the disposal was caused solely by the act or omission of a third party, 3) “all appropriate inquiry” was made into previous ownership and uses of the property, 4) despite this inquiry, the landowner did not know and had no reason to know that any hazardous substance was disposed of at the facility, 5) the landowner exercised “due care” with respect to the hazardous substances, and 6) precautions were taken against the foreseeable consequences of the acts and omissions of the third party that caused the problem.

This is a formidable set of hurdles to avoid liability for a problem that the landowner did not cause. However, from the perspective of someone considering the purchase of real estate, the most glaring problem with this defense is the nature of its availability: It is necessary to make “all appropriate inquiries” about the property and yet have no reason to know that hazardous substances were disposed of. If the inquiry uncovered reasons to believe that hazardous substances had been disposed of, the defense was not available. On the other hand, if the prospective purchaser did an investigation and hazardous substances were later found, there was a significant risk that the earlier investigation would be found to be insufficient. As a result, this defense was useless to someone hoping to redevelop a property with known contamination issues and was of little comfort to any other purchaser of real estate.

**Continuing Risks**

Unfortunately, the BRERA amendments to CERCLA represent a similarly timid response. They create the possibility of purchasing a known contaminated property without incurring CERCLA liability by establishing a new defense of being a bona fide prospective purchaser, but this defense is burdensome to establish. The amendments also specify that certain owners of properties contiguous with contaminated sites are not considered liable persons, but they place many restrictions on the availability of this relief. These statutory forms of relief have a dark side in that they suggest liability for owners who previously had good arguments against liability. The standards for qualifying as an innocent purchaser have actually been made tougher. Funding is available for planning and site characterization, but only through local government entities and only in limited amounts.

Perhaps the best example of these limitations is the new CERCLA Section 107(r)(1). At first blush, the section seems straightforward: It provides that bona fide prospective purchasers are not liable as owners or operators as long as they do not “impede the performance of a response action or natural resource restoration.” However, the simplicity vanishes when one reads the definition of “bona fide prospective purchaser.” In addition to specifying that the defense only applies to persons who purchased property after January 11, 2002, the definition places eight conditions that one must meet to be considered a bona fide prospective purchaser: 1) all disposal of hazardous substances must have occurred prior to acquisition, 2) the purchaser must have made all appropriate inquiry into previous uses (much like an innocent purchaser), 3) the person must have provided all legally required notices regarding the release of hazardous substances, 4) the person must exercise appropriate care with respect to the hazardous substances, including reasonable steps to prevent or limit exposure, 5) the purchaser must provide full cooperation to anyone authorized to take response actions, 6) the purchaser must comply with established land use restrictions and avoid doing anything that would impede the effectiveness or integrity of any institutional control, 7) the purchaser must comply with EPA subpoenas and requests for information, and 8) the purchaser must not be affiliated with any other liable person.

For many reasons, this long list should give pause to anyone hoping to qualify as a bona fide prospective purchaser. Failure to meet any one of these criteria—and many of them are quite complex—relegates the buyer to the status of liable party, doomed to the long and expensive process of negotiating or litigating a share of liability with other liable parties—or, worse yet, left as the only deep pocket at a site where the other liable parties...
be imposed, perhaps long after acquisition, that will be at odds with the planned or actual development of the property. The bona fide purchaser may not have much influence on these cleanup decisions for many reasons, including the fact that the decision maker will know that bona fide purchasers who do not cooperate lose their defense.

The potential for trouble does not end there. Another criterion requires the purchaser to take “appropriate care” with the hazardous substances found at the facility to stop releases, prevent future ones, and limit exposure.20 The phrase “appropriate care” is new to the CERCLA regime—previously, persons trying to qualify for the preexisting defenses in Section 107(b)21 had to show that they had exercised “due care” with regard to hazardous substances found at the site.22 It remains unclear what, if any, difference the courts will find between “due care” and “appropriate care.” And when that issue is addressed, another will remain regarding what kind of steps will be “appropriate” to stop releases, prevent future ones, and limit exposure. Finally, differences between the provisions for the bona fide prospective purchaser and the owner of contiguous property raise troubling questions about what will be required to meet the appropriate care element of this defense. Accordingly, an attorney can offer no clear advice to a client about how to avoid becoming a liable party after the property is acquired.

The criterion that all disposal needs to occur before acquisition also contains a trap. To the uninformed, the provision sounds simple: If the purchaser does not add any contamination, there is no liability. However, examination of the CERCLA case law reveals how wrong this reading may be. The holding in Kaiser Aluminum & Chemical Corporation v. Catellus Development Corporation,23 for example, is that moving contaminated soil to uncontaminated portions of the property constitutes disposal. CERCLA’s definition of a hazardous substance pays no regard to quantity, so it is actually quite likely that any redevelopment of a brownfield property could involve this kind of “disposal.” Thus, the criterion can easily be violated unwittingly during redevelopment.

Even if the purchaser does nothing to move existing contamination, this condition may still be violated. The possibility arises from the holding in Nurad v. William E. Hooper & Sons, Inc.,24 in which the court found that “the reposing of hazardous waste and its subsequent movement through the environment” can constitute disposal under CERCLA.25 While several circuit courts, including the Ninth Circuit, have explicitly rejected the notion that the passive migration of contaminants through soil, without more, constitutes disposal for CERCLA purposes,26 the rationale for these cases has been undercut by provisions in BRERA concerning the liability of owners of properties contiguous to the source of hazardous substance releases. In short, if the passive migration of contaminants is not disposal under CERCLA, then these contiguous owners would not be liable, and it would not be necessary to establish a defense to protect them. Thus, the contiguous landowner defense may render meaningless the relief that is supposedly afforded by the bona fide prospective purchaser defense. Undoubtedly, the courts will have to decide what this muddle means.

As if all that were not enough to deter anyone from relying on being a bona fide prospective purchaser, BRERA goes on to provide that if EPA has unrecovered response costs in connection with the “facility” (which could include properties beyond the one purchased),27 EPA is entitled to place a lien on the property for less than or equal to the amount that the cleanup increases the fair market value of the property.28 The possibility of such a lien raises questions about the purchaser’s potential return on investment and carries the prospect of litigation over the amount of the lien. Just as important, if the property is acquired with a loan, the imposition of such a lien runs a high probability of violating the terms of the deed of trust securing the loan.

Contiguous Property Owners

If the bona fide purchaser provisions are a trap for the unwary, BRERA’s provisions on contiguous properties are a dangerous solution in search of a problem to justify their creation. To summarize these provisions is challenging because the statute contains needlessly complex grammatical structures,29 making one wonder if some darker meaning is being intentionally obscured. Under BRERA’s provisions, owners or operators of properties contaminated by off-site sources can escape liability if they meet eight criteria which in simplified form are that the person 1) did not cause, contribute, or consent to the release, 2) is not affiliated with someone who is liable for the release, 3) takes reasonable steps to stop the release and limit human or environmental exposure (note the absence of either “due care” or “appropriate care,” which are found in otherwise parallel requirements for the innocent purchaser and bona fide purchaser defenses), 4) provides full cooperation to those conducting the cleanup, 5) is in compliance with land use restrictions established as part of the response and does not interfere with other institutional controls associated with the release, 6) is in compliance with any information request from EPA, 7) provides all legally required notices with respect to the release of hazardous substances, and 8) conducted appropriate inquiry into the property at the time of acquisition and yet had no reason to know of the contamination.30

This defense raises the question of what need it fills. Arguably, it was necessary because of the holding in Nurad that the passive migration of contaminants constitutes a disposal under CERCLA. Under this logic, since passive migration is “disposal,” people whose property is contaminated by hazardous substances migrating from off the site are “owners and operators” at the time of disposal and thus liable under CERCLA. However, Nurad appears to be a minority view among the circuits.31 Thus, on the basis of case law, adjoining property owners (especially those in the Second, Third, Sixth, and Ninth Circuits) have had a good argument that they were not liable at all under CERCLA. Besides, if Nurad were the problem, a simpler solution is available—namely, a provision indicating that passive migration from an off-site source is not a basis for liability under CERCLA.

There is also a practical reason to question the necessity for the contiguous property owner provisions of BRERA. Little or no evidence exists that contiguous owners have been subject to liability claims. For example, contaminated aquifers underlie large parts of the San Fernando and San Gabriel Valleys, and the contamination in these aquifers continues to migrate. This situation theoretically makes most of the property owners in those areas liable under CERCLA as owners of facilities at the time of disposal, if disposal includes passive migration. Yet to date neither the government nor the private parties that have been the subject of government cleanup claims have sought recovery from these so-called contiguous property owners.32 Although there were some problems with lenders who were concerned about this source of liability, those concerns appear to have subsided, and lending is a problem in these areas only for properties for which data suggests that they may be a source of contamination.

Yet another reason to question the need for this defense is EPA’s 1995 document titled “Policy toward Owners of Property Containing Contaminated Aquifers.”33 In the policy, EPA indicated that, subject to certain conditions, it would not take enforcement action or seek cost recovery from those defined as contiguous property owners under BRERA. EPA based its policy on the notion that such contiguous property owners could claim the defense, already existing in Section 107(b)(3) of CERCLA,34 that the release was
caused solely by the act or omission of a third party. If this indication is true, why did Congress create a new defense rather than simply continue to rely on the third-party defense found in Section 107(b)(3)? That defense has fewer conditions and would not have raised questions about whether Congress intended that passive migration constituted disposal.36

As it stands, this new defense raises the implication that Congress agreed with the theory of Nurad that passive migration constitutes disposal. In so doing, it undermines the holdings of the courts that have declined to follow Nurad. Those holdings may be saved by Section 107(q)(2),37 which provides that the new subsection does not limit any existing defenses or create any new liability. However, that seems to be small comfort in the face of the rest of the section, which imposes many conditions on the availability of this new defense and adds even more confusion to CERCLA’s already confusing liability provisions. Those daring to take advantage of this new defense will have to face its shortcomings. The most glaring is that it shares the Catch-22 of the original innocent purchaser defense; namely, it is unavailable if the person acquiring the property had reason to know of the contamination prior to acquisition. This requirement makes the defense useless to anyone wishing to redevelop a brownfield property. Like the bona fide purchaser defense, its availability further depends on events that can occur after acquisition, such as compliance with land use restrictions established as part of the hazardous substance response and compliance with EPA information requests.

One (rather limited) positive aspect of this provision is that Congress specified that the requirement to take reasonable steps to stop or prevent releases does not include a requirement to conduct groundwater investigations or install groundwater remediation systems, except as required by the “Policy toward Owners of Property Containing Contaminated Aquifers.”38 That policy only requires this action in unspecified “exceptional circumstances” or if operation of an existing groundwater well on the property affects the migration of contaminants. The dark side of this provision is that no similar limitation was placed on the obligations of bona fide prospective purchasers, who must comply with a virtually identical appropriate care provision to qualify for that defense.39 Does this mean that Congress concluded that bona fide purchasers might, in some circumstances, have to conduct groundwater investigation or remediation to preserve their status? Was this an intentional policy choice or just sloppy drafting? One suspects the latter, but ultimately it will probably be the subject of an appellate decision.

With a similarly double-edged sword, Congress gave EPA the explicit authority to grant persons qualifying for this defense assurances that no enforcement action will be brought or offer protection against cost recovery and contribution suits.40 No such provision was included for bona fide prospective purchasers, again raising the question of whether this was just an oversight or an intentional policy choice. Since EPA stated in its 1995 policy that it intended to make such relief available to contiguous owners, this provision provides another source of dread about why it was necessary.

Complicated Innocence

Another telling sign that BRERA was not necessarily designed to alleviate the harshness of CERCLA liability is that the innocent landowner defense (which was the original, limited form of CERCLA liability relief) was made more complicated and harder to demonstrate under BRERA. The first source of complication is the six new conditions that a landowner must meet to qualify for this defense. Specifically, a landowner must now 1) provide full cooperation to EPA’s response, 2) comply with any land use restrictions established in connection with EPA’s response actions, 3) not do anything that interferes with any institutional control that is part of the response action, 4) take reasonable steps to stop any continuing release, 5) take reasonable steps to prevent any future release, and 6) take reasonable steps to prevent or limit human or environmental exposure to the contamination.41

These new conditions are puzzling, in light of the fact that to establish the innocent landowner defense, a person already had to demonstrate that due care was exercised with regard to the hazardous substance and that precautions were taken against the foreseeable consequences of the acts or omissions of the third party who caused the contamination.42 It would be convenient if these new conditions were merely meant to be a clarification of what constitutes due care and precautions. Nevertheless, given how these amendments are structured, it is equally plausible to argue that these conditions are in addition to the requirements of Section 107(b)(3) for due care and precaution. However, even if the new requirements are read as defining “due care” and “precaution,” this significantly limits the discretion of a court to fashion standards that are tailored to the facts of the transaction before it.

Another source of complication for the innocent landowner defense arises from the statute’s attempt to standardize preacquisition environmental due diligence. The BRERA amendments direct EPA to promulgate standards for what constitutes “all appropriate inquiries” for the purposes of establishing this defense.43 This has the potential to be a positive development, as long as EPA does not create unreasonable standards. However, the amendments also established an interim criterion for property purchased after May 31, 1997; the 1997 version of the Standard Practice for Environmental Site Assessment: Phase I Environmental Site Assessment Process, published by the American Society for Testing and Materials.44 This has the potential to be a complication for current transactions, because the ASTM has updated its Phase I standard since issuing the 1997 standard.45 Thus, an attorney should counsel a client that is considering a purchase to request the consultant doing the Phase I assessment to represent that the report will meet both the 1997 standard and the 2000 standard.

This provision may spell trouble for anyone who acquired property after May 31, 1997, and did not conduct an investigation that complied with the 1997 ASTM Phase I standard. Twenty-two years after CERCLA’s passage, there are still people who buy industrial or commercial properties without environmental investigation. At a less extreme level, many people seemed to think that the more abbreviated investigation represented by the ASTM Transaction Screen46 was a sufficient investigation in some circumstances. Hopefully, when EPA adopts a new standard, it will not be retroactive.

BRERA not only offers new hazards but also lacks incentives to brownfields redevelopment. Few, if any, of BRERA’s carrots come in the form of liability relief. Subtitle A of BRERA47 authorizes EPA to establish a grant program to state and local governments to allow those local entities to engage in remediation themselves or make loans to site operators or developers. BRERA places limitations on the kind of sites for which this assistance is available, specifically excluding sites that are the subject of cleanup orders (even orders on consent) under many federal and state programs.48 The amounts are limited—a maximum of $1 million to each state or local government, and a maximum loan of $200,000 to an owner or developer. While these amounts may be significant for a particular project, the limited amount of authorized appropriations—a maximum of $200 million over five years—together with the limitation on eligible sites, guarantees that this program is not likely to have widespread impact.

Since BRERA affords little in the way of either liability relief or financial incentives, it
is likely that brownfields redevelopment will continue to be driven by the market forces that have driven it to date—namely, the need for retail, and in some cases, residential development in urban and suburban areas where a location has become attractive because of changes in surrounding uses and development. Redevelopment will be far more likely where the contamination can be addressed relatively cheaply, or there is a solvent party who is already cleaning up the property, or a redevelopment agency has taken on the burden of getting the site cleaned up.

Lawyers representing parties seeking to acquire brownfield properties will have to rely on the tools that have already been developed for these deals. The cornerstone of the approach to doing the deals is a thorough investigation of the property, including the history of the property’s use, the sources of the contamination, and its potential impact on the planned development. The investigation needs to be performed by competent engineering and scientific professionals. The information gathered is essential to advise the prospective purchaser about the risks involved in the deal and how best to protect against them.

Probably the best way to protect against risk is through indemnities and cleanup agreements with other parties who are responsible for the contamination, if those parties have significant resources. Agreements with the government agency that has jurisdiction over the cleanup can be very useful in making financing more available or clarifying the responsibility of the prospective purchaser, especially if there are questions or limitations concerning the ability of other liable parties to perform the cleanup. More often than not, these agreements are with state and local agencies rather than EPA.

There are many reasons for this. Historically, EPA has not been receptive to making agreements with prospective purchasers (although it has done so in the past, especially for high-profile projects having strong support from local political leaders). Probably more important, state and local agencies supervise far more cleanups. There are even some kinds of contamination—such as that associated with gasoline stations—that are beyond CERCLA’s statutory reach. If anything, the BRERA amendments will only increase the likelihood that any agreement from the government to protect a prospective purchaser will be with a state or local agency, as EPA has taken the position that formal agreements are less necessary now that there are so-called protections available in the statute. The BRERA amendments, however, do not affect liability under California environmental statutes.

Environmental insurance is another approach that has been used to facilitate deals on properties with contamination issues. In general, however, it is an approach that consumes large amounts of time and money, since the policies almost always need to be specifically negotiated. The market for these products also changes rapidly. Thus, it is difficult to say whether BRERA will have any significant impact on the availability of these products as a solution to making brownfields deals work.

BRERA offers little reform, little incentive to do brownfields deals, and little reason to think that the fundamental ways of doing these deals will change. The amendments do, however, add significant complication to an already complicated statutory scheme and many potential traps for those who might be tempted to take advantage of the so-called reforms being offered. The treacherous conditions that BRERA places on the defenses it creates, and its quirky drafting, will require lawyers who advise clients about its applicability to think long and hard about the possible implications of BRERA’s terms. Caveat emptor.
fund Amendments and Reauthorization Act of 1986, or SARA.

13 42 U.S.C. §§9601(35), 9607(b)(3).

14 Id.


16 Id.

17 42 U.S.C. §9601(40).

18 Id.

19 An institutional control is usually a restriction on the use or development of the property—e.g., a deed restriction forbidding residential use or a requirement to maintain paving over a certain area of the site—that is designed not to achieve actual cleanup but rather to prevent the spread of contamination or exposure to it.


21 42 U.S.C. §9607(b).

22 Id.


25 Id.

26 Carson Harbor Village Ltd. v. Unocal Corp., 270 F. 3d 863, 879 (9th Cir. 2001), cert. denied, 122 S. Ct. 1437 (2002); Colorado v. Idarado Mining Co., 707 F. Supp. 1227 (D. Colo. 1989), where it was held that areas of a river where mine tailings had come to be located were a facility within the meaning of CERCLA despite the fact that these areas were downstream of where the defendant mining companies had actually deposited them.

27 “Facility,” as defined in CERCLA at 42 U.S.C. §9601(9) and in implementing regulations at 40 C.F.R. §300.5, includes “any site or area where a hazardous substance has been deposited…or come to be located….” Thus, a CERCLA facility is not limited to a particular legal parcel and can encompass a large area. See, e.g., Carson Harbor Village Ltd. v. Unocal Corp., 270 F. 3d 863, 879 (9th Cir. 2001), cert. denied, 122 S. Ct. 1437 (2002); United States v. 150 Acres of Land, 204 F. 3d 698, 705-06 (6th Cir. 2000); ABB Indus. Sys., Inc. v. Prime Tech., Inc., 120 F. 3d 351, 358 (2d Cir. 1997); United States v. CMDB Realty Co., 96 F. 3d 706, 711 (3d Cir. 1996).

28 42 U.S.C. §9607(r).

29 E.g., “A person that owns real property that is contiguous to or otherwise similarly situated with respect to, and that is or may be contaminated by a release or threatened release of a hazardous substance from, real property that is not owned by that person….” 42 U.S.C. §9607(q)(1)(A).

30 See note 26, supra.

31 42 U.S.C. §9601(40)(D).


33 The innocent landowner defense was created by expanding the definition of “contractual relationship.” To qualify as an innocent landowner one had to prove that the contamination was caused by the act or omission of a third party with whom one did not have a contractual relationship as well as establishing the other elements of the §107(b)(3) defense. Since the purchase of real estate presumably created a contractual relationship, the defense was created by specifying that in certain conditions, this purchase/sale agreement did not qualify as a contractual relationship.


36 While EPA policy is not necessarily a binding interpretation of the law, it is usually given substantial deference if the agency is interpreting a statute it has the authority to administer and Congress has not clearly addressed the question at issue. Chevron v. Natural Resources Defense Council, 467 U.S. 837, 842-45 (1984).

37 42 U.S.C. §9607(q)(2).


40 42 U.S.C. §9607(q)(2).


42 The policy toward Owners of Property Containing Contaminated Aquifers, 60 Fed. Reg. 34790 (July 3, 1995).

43 42 U.S.C. §§9601(35), 9607(b)(3).

44 Id.

45 Id.

46 Id.

47 AMERICAN SOCIETY FOR TESTING AND MATERIALS, STANDARD PRACTICE FOR ENVIRONMENTAL SITE ASSESSMENT: TRANSACTION SCREEN PROCESS, E1528-00 (2000).

48 42 U.S.C. §§9601(35), 9604(k).

49 Wilshire Westwood Assocs. v. Atlantic Richfield Co., 881 F. 2d 801 (9th Cir. 1989).

50 Memorandum, Bona Fide Prospective Purchasers and the New Amendments to CERCLA, from Barry Breen, Director, OSRE to Superfund Senior Policy Managers and Regional Counsels (May 31, 2002).

51 The one exception to this may be that BRERA’s changes to the innocent purchaser defense may flow through to California’s state Superfund law, more formally known as the Carpenter-Presley-Tanner Hazardous Substance Account Act, HEALTH & SAFETY CODE §§25300 et seq. See HEALTH & SAFETY CODE §25323.5(b).
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In 1965, there were 500 residential community associations in the United States. Today, there are more than 231,000. An estimated 47 million Americans now live in residential community associations. The demand for new common interest developments has spurred a construction boom of unprecedented proportions over the past 20 years, and the California legislature has struggled to keep up with the pressures that this phenomenon has imposed on the courts. In the early stages of the boom, developers began to feel overwhelmed by the number of lawsuits initiated by homeowners’ associations alleging defects in the design and construction of their planned communities.

The legislature and the governor responded to this problem in 1995 by enacting Civil Code Section 1375 with the hope that it would provide an efficient mechanism for resolving disputes between homeowners’ associations and developers before the filing of a lawsuit. Although well intended, the results have been mixed at best, most likely as a result of the flaws inherent in the statute. Indeed, the dispute resolution process often seemed to be nothing more than a speed bump on the road to full-blown litigation. Among other shortcomings, the statute’s pre-litigation period was too short—and its penalties for noncompliance were too vague—for the dispute resolution process to be meaningful. The process clearly needed more teeth.

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Defective Solutions

Legislation intended to encourage the resolution of condominium defect disputes may inhibit effective association management.
to be truly effective.

To address this need, on October 12, 2001, Governor Davis signed into law SB 1029, a bill that, effective July 1, 2002, made several significant changes to Civil Code Section 1375 with the aim of strengthening the usefulness of the dispute resolution mechanism. Nevertheless, the new amendments to Section 1375 may have rendered the prelitigation process too rigid and complex for meaningful settlements to be reached. Ironically, the revised Section 1375 may have unwittingly frustrated the original purpose of the statute—namely, the orderly and efficient resolution of disputes.

When the state legislature originally enacted Civil Code Section 1375, which is commonly known as the Calderon Process, it was seeking to stem the tide of construction defect litigation and was no doubt prompted by lobbying efforts on behalf of the construction industry. The purpose of the Calderon Process was to provide a prelitigation forum for the informal resolution of construction defect claims brought by homeowners’ associations.

In essence, the law required associations to engage in a structured settlement process before commencing suit against a real estate developer for defective design or construction of a development of 20 units or more. Specifically, the law provided that before filing a complaint, the association must give written notice to the developer identifying the name and location of the project, a defect list, and the results of any testing or surveys. Any association that failed to satisfy this notice requirement risked having its action stayed by the trial court or dismissed.

Service of the notice triggered a 90-day window in which the developer and the association were to “attempt to settle the dispute or attempt to agree to submit it to alternative dispute resolution.” The developer had the right to conduct additional discovery to further settlement efforts. At some point, both the developer and the association were supposed to meet and confer concerning any settlement offer or proposal for alternative dispute resolution.

The association was also required under the statute to communicate with the individual homeowners to discuss the merits of any proposed settlement offer. If the developer was unwilling to participate in the settlement process, however, the association’s responsibilities under the statute were excused.

The Calderon Process, as originally enacted, contained three basic flaws. First, the 90-day period in which the parties were to meet and confer was simply too short for accomplishing what needed to be done. By the time the developer had finished analyzing the association’s defect list and related materials and had conducted its own inspection and testing, the 90-day period typically had expired. Additionally, there was simply not enough time to bring in subcontractors, insurance representatives, and other parties necessary to bring about an effective resolution of the dispute.

Second, subcontractors and insurers were not required to participate in the process. Without the participation of subcontractors and insurers, developers were left alone to grapple with the economic burdens of settlement. In many circumstances, the absence of these necessary parties in the Calderon Process forced developers to bring subsequent indemnity suits against subcontractors, which resulted in increased litigation.

Third, the statute was vague regarding the penalties to be imposed on parties who failed to adhere to the Calderon Process pro-
procedures. Many parties—developers and associations alike—simply chose to disregard the prelitigation process and march directly into litigation.

According to one commentator, ultimately the statute had “little to do with ADR or settling claims prior to litigation” but instead had “more to do with homeowner-association politics and deterrence of construction-defect claims.”

Critics of the Calderon Process, spearheaded by the insurance industry, were vocal early and often. And in late 2000, after the California Supreme Court in *Aas v. Superior Court* barred construction defect plaintiffs from recovering damages for economic loss when the alleged defects do not cause property damage, it became readily apparent that a significant overhaul of the entire construction defect resolution process—including both the prelitigation and litigation aspects—was necessary.

The first step was the revision of Civil Code Section 1375 in 2001, which effected changes in the prelitigation dispute resolution process. The next step was the passage of SB 800 in 2002, which sets forth the framework for construction defect litigation after *Aas* and also contains prelitigation procedures as well. Revised Section 1375, which became effective July 1, 2002, remains applicable for specified developments sold before January 1, 2003; SB 800 applies to all residential property sold after that date. (See “In the Wake of *Aas*,” page 40.)

**Revised Civil Code Section 1375**

The revised Civil Code Section 1375, like the original statute, requires an association to give written notice to the developer. The notice, titled the “Notice of Commencement of Legal Proceedings,” must include the name and location of the project, an initial defect list, a summary of the damages resulting from the defects, and either a summary of the results of testing and surveys or the actual test results.

The revised statute also tolls all statutes of limitations on all parties for 180 days, which is an increase from the 150-day tolling period in the previous incarnation of Civil Code 1375. The parties can also agree to a further extension of up to another 180 days. The revised statute still allows for an early meeting between the developer and the board of the association. In keeping with the legislature’s intent on keeping the prelitigation process moving quickly and efficiently, the developer must call for the meeting within 25 days of the association’s service of the Notice of Commencement of Legal Proceedings. The discussions at the early meeting are privileged communications and are not admissible in any subsequent civil action. This clarifies a point that was left ambiguous in the language of the earlier statute.

The legislature’s goal of expediting the prelitigation process is also reflected in the revised statute’s provisions dealing with document exchange. Civil Code Section 1375 now requires the developer to provide the association with full access to all plans, specifications, subcontracts, and other construction files for the project. Similarly, the association must provide the developer with access to all documents concerning the claimed defects, including all reserve studies, maintenance records, survey questionnaires, and test results. The same rules apply for subcontractors and all third parties involved in the dispute.

The inclusion of subcontractors as well as design and related professionals (and their insurance companies) in the ADR process is advance” in order to allow the relevant parties to attend the initial inspection (or, if requested, the second inspection) “of any alleged unmet standard and to participate in the repair process.”

- **Second inspection and testing.** If considered “reasonably necessary,” the developer can conduct a second inspection and testing within 40 days of the initial inspection and testing.

- **Offer to repair.** If the developer believes that repairs are warranted, the developer may, within 30 days of the inspection and testing, offer in writing to repair the violation. The offer to repair should also compensate the homeowner for all reasonable relocation and storage expenses, lost business income (if there is any), “investigative costs,” and “all other costs or fees recoverable by contract or statute.” These provisions of the new law regarding the applicable damages that may be part of the offer to repair specifically override *Aas*.

The offer to repair also must include a detailed, specific, step-by-step statement 1) identifying the particular violation that is being repaired, 2) explaining the scope, nature, and location of the repair, and 3) setting a reasonable completion date for the repair.

- **Authorization to proceed with repair.** The homeowner has three options once the developer’s offer to repair is received. The homeowner can 1) authorize the developer to proceed with the repair, 2) request that the developer provide the names of three contractors other than the developer or the original contractor to perform the work, or 3) proceed to mediation.

- **Use of alternative contractors.** If the homeowner elects to use an alternative contractor to perform the repairs, the developer (who may also be the original contractor) is entitled to an additional noninvasive inspection of the premises to permit the proposed contractors to review the proposed site of the repair. The developer has 35 days from the date of the homeowner’s request for the names of other contractors to comply with the request. The homeowner then has 20 days to authorize either the developer or one of the three proposed alternative contractors to perform the requisite repairs.

- **Mediation.** The parties may choose to resolve their dispute through mediation. Either the developer selects and pays for the mediator or the developer and homeowner agree to split the cost and jointly select the mediator. The statute provides for a mediation limited to four hours unless the parties mutually agree to another arrangement.
likely the most significant positive development in the revised statute. The revised statute now requires the developer to forward the Notice of Commencement of Legal Proceedings to these parties within 60 days of service of the original notice on the developer. The association, developer, and all relevant subcontractors and their insurers are deemed “nonperipheral parties” and are required to attend the case management meeting, participate in the selection of the neutral mediator (whom the statute refers to as the “dispute resolution facilitator”), and participate in other discovery and settlement sessions under the revised statute.

Once involved, any minor subcontractor or design professional whose total claimed exposure is less than $25,000 can make a request to be designated a “peripheral party.” If no objection to that designation is received within 15 days, the subcontractor or design professional is only obligated to participate in dispute resolution sessions deemed “peripheral party sessions.”

The revised statute thus tries to strike a balance between having developers bear alone the burden of responding to and settling a construction dispute and involving subcontractors and like parties in the settlement. This balance is accomplished without procedures that completely clog the dispute resolution process.

The revised statute emphasizes the role of the neutral mediator. All involved parties must meet and confer to select the dispute resolution facilitator within 20 days of the developer’s service of its notice on subcontractors. The dispute resolution facilitator’s powers and duties are vaguely defined, however. The revised statute states that the role of the facilitator is to “attempt to resolve the conflict in a fair manner.” The facilitator must be “sufficiently knowledgeable in the subject matter and be able to devote sufficient time to the case.” But there is little guidance on determining the appropriate grounds for rejection of a proposed neutral beyond the standard grounds specified in Code of Civil Procedure Section 170.1 for the disqualification of a judge based on a prior relationship. Ultimately, selection of the facilitator is left to the auspices of the court if the parties cannot agree on one themselves.

The facilitator’s chief role is to preside over the case management meeting, which must be held within 100 days of service of the association’s notice to the developer. The primary purpose of the case management meeting is to develop a case management statement in which the parties detail the technical aspects of the case. Among the items outlined in the case management statement are the use of a document depository and dates for visual inspection and invasive testing.

Once the procedural aspects of the case management statement have been accomplished, the focus of the resolution process under revised Civil Code Section 1375 shifts to settlement negotiations. The provisions of the revised statute that address settlement issues represent a drastic departure from the old scheme.

First, the revised statute allows a developer hoping to resolve a dispute to submit:
- A request to meet with the board of the association to discuss a written settlement offer.
- A written settlement offer to the association.
- A statement that the developer has sufficient funds to satisfy the conditions of the settlement offer.
- A summary of the developer’s test results, if any.

The statute is ambiguous as to whether the developer must submit all these items or whether the developer can pick and choose among them.

If the developer chooses to submit a settlement offer, the revised statute further requires the association’s board to hold an...
The Los Angeles County Bar Association certifies that this activity has been approved for Minimum Continuing Legal Education credit by the State Bar of California in the amount of 1 hour.

1. Civil Code Section 1375 was first enacted in:
   B. 1993.

2. Civil Code Section 1375 only applies to disputes between homeowner associations and real estate developers for defective design or construction of developments of 20 units or more.
   True.
   False.

3. Under the revised version of Civil Code Section 1375 that became effective July 1, 2002, the statute of limitations on all claims is tolled 150 days.
   True.
   False.

4. Revised Section 1375 requires the developer to forward the Notice of Commencement of Legal Proceedings to subcontractors, design professionals, and their insurers within 25 days of service of the original notice.
   True.
   False.

5. Revised Section 1375 still allows for an early meeting between the developer and the board of the association.
   True.
   False.

6. Discussions at an early meeting are privileged communications and are not admissible in any subsequent civil action.
   True.
   False.

7. In order to be a dispute resolution facilitator, one must:
   A. Have at least 5 years’ experience as a court-appointed neutral.
   B. Be sufficiently knowledgeable in the subject matter and be able to devote sufficient time to the case.
   C. Be confirmed by the presiding judge of the court.
   D. All of the above.
   True.
   False.

8. In furtherance of settlement, revised Section 1375 allows the developer to submit to the association:
   A. A written settlement offer.
   B. Test results.
   C. A request to meet with the association’s board.
   D. All of the above.
   True.
   False.

9. A party that participates in the prelitigation process without settlement authority is bound by any subsequent settlement reached.
   True.
   False.

10. The case management meeting must be held no later than 30 days before the association files its lawsuit.
    True.
    False.

11. A subcontractor whose total exposure is less than $25,000 may be considered a peripheral party.
    True.
    False.

12. The board cannot initiate a lawsuit against the developer until it discusses any formal settlement offer proposed by the developer with the members of the association at an open meeting of the members.
    True.
    False.

13. Revised Section 1375 requires the developer to personally attend any open meeting of the association’s members.
    True.
    False.

14. SB 800 applies to all residential property sold January 1, 2003, or later.
    True.
    False.

15. New Civil Code Sections 875 et seq. apply only to real estate developments of 20 units or more.
    True.
    False.

16. Under the new procedures in SB 800, the developer must give notice of a planned inspection and testing to subcontractors, design professionals, and other parties related to the dispute:
    A. Within 14 days of receipt of the homeowner’s notice.
    B. Within 25 days of receipt of the homeowner’s notice.
    C. Within 60 days of receipt of the homeowner’s notice.
    D. Sufficiently in advance of the inspection and testing.
    True.
    False.

17. According to SB 800, the developer can conduct a second inspection and testing of the premises at issue as a matter of right.
    True.
    False.

18. Under SB 800, the developer may, within 30 days of any inspection and testing, offer in writing to repair the violation.
    True.
    False.

19. According to SB 800, after the homeowner receives the developer’s offer to repair, the homeowner may select an alternative contractor to perform the repairs—but the contractor must be one of three designated by the developer.
    True.
    False.

20. If the parties agree to mediate their dispute, under SB 800 the mediator will be selected and paid for by the developer unless the homeowner agrees to split the cost.
    True.
    False.

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5. □ True □ False
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7. □ A □ B □ C □ D
8. □ A □ B □ C □ D
9. □ True □ False
10. □ True □ False
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12. □ True □ False
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15. □ True □ False
16. □ A □ B □ C □ D
17. □ True □ False
18. □ True □ False
19. □ True □ False
20. □ True □ False
open meeting of the association to discuss the offer. If the board decides to reject the offer, the open meeting must still occur, where the discussion presumably will include the board’s rationale for its decision to reject the developer’s offer of settlement.25

The importance of this requirement for an open association meeting following the submission of an offer by a developer should not be understated. The board cannot initiate formal litigation against the developer until such a meeting is held.26 Additionally, the board is required to send each member of the association written notice about the meeting. In connection with this meeting, the revised statute requires that the board provide specified information in writing to the association, including:

• “That a meeting will take place to discuss problems that may lead to the filing of a civil action, and the time and place of this meeting.”27

• “The options that are available to address the problems, including the filing of a civil action and a statement of the various alternatives that are reasonably foreseeable by the association to pay for those options and whether these payments are expected to be made from the use of reserve account funds or the imposition of regular or special assessments, or emergency assessment increases.”28

Thus the statute now forces the association’s board from the onset of the dispute to present worst-case scenarios to association members, thus increasing the chances for dissension among the ranks of the association. The board could essentially find itself in the middle of hostile forces, including the developer on the one hand and a potentially dissatisfied association on the other.

• “The complete text of any written settlement offer, and a concise explanation of the specific reasons for the terms of the offer submitted to the board at the meeting....”29 In essence, revised Civil Code Section 1375 gives the developer unfettered access to association members, against whom the developer may use scare tactics to dissuade members from supporting a board’s decision to proceed with litigation. For example, a developer with no intention of settling can make a nominal written settlement offer and include reasons why litigation would not be in the association’s best interests: It will be too costly, will damage the market value of residences, and the like. This provision of the revised statute seems designed to undermine board authority and decision making in favor of mob rule. Association boards are now placed in the unenviable position of deciding between what may be right and what may be popular.

With all its flaws, the requirements of the
revised statute must be followed or penalties will ensue. Parties to a construction dispute can no longer circumvent or hope to delay the process by refusing to participate or hiding behind mountains of discovery and protracted litigation. To deter this kind of conduct, the legislature created new penalties to encourage participation in the new scheme. The revised statute provides that any party that does not participate in the process, or participates without settlement authority, is bound by any subsequent settlement reached. Moreover, the revised statute severely restricts the ability of the parties to conduct further discovery once a complaint is filed. Finally, a new section of the Civil Code, Section 1375.05(b), provides that for purposes of trial setting, the complaint in any action that falls under Section 1375 is deemed to have been filed on the original date of service of the association’s Notice of Commencement of Legal Proceedings, and the case will be given the earliest possible trial date.

**Chilling Effect**

Even if the parties do reach a successful resolution of the dispute, the requirements imposed on the association after settlement are hardly conducive to participating in the revised statute’s settlement process.

In the first place, according to Civil Code Section 1375.1, the association must disclose to its members not only a description of the defects to be corrected and the date of completion of the work but also the status of all defects originally identified but not included in the final settlement agreement. Essentially, this provision forces the association to disclose to its members those items on which it compromised. Therefore, even if the board reaches an agreement that it feels is in the best interests of its members, it may be faced with the unenviable task of having to explain itself to its constituents.

Perhaps even more troublesome are the privilege issues implicated by requiring such a disclosure. Many if not all associations retain legal counsel to help them navigate through myriad tasks and procedures. Legally, the attorney's duty is to the association—not to the individuals who are represented by the association. However, forcing the association to disclose what it chose to give up in the spirit of compromise is akin to disclosure of trial tactics and would appear to be a clear violation of the attorney-client privilege.

The settlement proposal provisions in revised Civil Code Section 1375, despite the legislative purpose of the statute, ultimately may prove to have a chilling effect on construction defect litigation and the prelitigation resolution of this type of dispute. While the
revised statute represents a noble attempt to remedy the ambiguities and shortcomings found in the earlier version of Section 1375, the legislature, in its effort to install structure and fluidity to a process that was largely amorphous and undefined, may have created what it feared most—rigidity and intractability.

Given the complexity of the legal and factual issues in construction defect disputes, and the likelihood of the involvement of numerous parties, many homeowners' associations may forego dispute resolution in favor of a more relaxed and deliberate process, such as informal settlement negotiations. Still, this course is risky, because a mandatory prerequisite for construction defect litigation is the utilization of the revised Civil Code Section 1375 pre-litigation resolution procedure.

Nevertheless, some plaintiff's groups may forego litigation altogether rather than face the harsh requirements of disclosure that accompany the new provisions of Civil Code Section 1375. The new statute may satisfy its goal of curbing litigation—but only by creating a huge disincentive to bring an action in the first place.

1 Figures from Community Associations Institute, at www.caionline.org.
2 State Senator Charles M. Calderon was the author of the bill that became Civil Code §1375.
3 See generally CIV. C ODE §1375(a), as added by SB 1029, 1995 Cal. Stat. ch. 864, §1.
4 CIV. CODE §1375(b).
5 Id.
6 See generally CIV. CODE §1375(g).
8 Aas v. Superior Court, 24 Cal. 4th 627 (2000).
9 CIV. CODE §1375(b).
10 CIV. CODE §1375(b)-(c).
11 CIV. CODE §1375(c).
12 CIV. CODE §1375(d).
13 Id.
14 CIV. CODE §1375(e)(1).
15 Id.
16 Id.
17 CIV. CODE §1375(e)(2).
18 CIV. CODE §1375(e)(3).
19 Id.
20 CIV. CODE §1375(f)(1).
21 Id.
22 Id.
23 CIV. CODE §1375(k)(1)(A).
24 CIV. CODE §1375(k)(1)(D).
25 CIV. CODE §1375(k)(1)(E)(i).
26 CIV. CODE §1375(k)(1)(E)(ii).
27 CIV. CODE §1375(k)(1)(E)(iii).
29 CIV. CODE §1375(k)(1)(E)(v).
30 CIV. CODE §1375.05(d).
31 For example, in most circumstances defendants are not permitted to conduct further inspections or testing once a complaint is filed.
32 CIV. CODE §1375.1.
Data backup is not terribly difficult, while the consequences of not performing backups can go beyond the cost of data recovery and encompass legal malpractice. Yet, new storage replication software, coupled with the falling cost of hardware and high-speed connections, has created the potential to eliminate the problems related to data backup, storage, and restoration. The small firm or sole practitioner who has been relying on divine protection now has no excuse not to establish a proper data backup system.

The value of a data backup system depends upon how well a law office understands the options available, its level of understanding of the technology, and how efficiently the software is used. Although there are approximately 200 software backup products, most operating systems now provide simple, effective data backup options. Fundamentally, a firm needs to set three cornerstones for data backup: an understanding of the technology and the needs of the firm, software, and hardware.

The first cornerstone dictates how the second two will be configured.

For example, if the amount of data is relatively small and the content of the data is relatively unimportant to the practice, then simply making CD backups of the data from time to time could be sufficient. This may be the case, for example, if a sole practitioner uses his or her computer as little more than an address book. If the data is critical to the practice, however, then a more robust (and expensive) solution is needed. The best method of data backup depends on the size of the firm, how much it needs the data, and how much it needs to keep its data up-to-date, among other factors.

In the typical law office, however, the firm’s data is its bread and butter. Restoring a hard drive is no trifle, so for most firms the time and the money spent on establishing an appropriate backup system and training people to use and maintain it amount to cheap insurance.

After a crash, an attorney who has to perform nothing more than a simple restoration of data is indeed lucky. Less fortunate is the attorney who has to perform a system restoration. If a hard drive fails completely, it will probably take days to restore a computer’s operating system, modem and network drivers, printer drivers, scanner driver, and all its complicated law office software.

If a computer’s hard drive is physically damaged or breaks down, data recovery may not be possible. Sending the hard drive to a data recovery firm is an option, but the results are unpredictable. With a physically disabled hard drive, however, this is the only way to accomplish data recovery. The cost (expect to pay around $1,500) is usually nonrefundable, due in advance, and without any guarantee that useful data can be extracted once the drive is repaired.

Moreover, if the firm cannot afford to operate without computers and their data for a few days, then a backup system that refreshes itself continually and that maintains a copy of an entire hard drive may be the most appropriate option. Such a system may involve new hardware, new software, and possibly the hiring of a consultant to install everything and get it working, but the alternative could be the loss (during trial, perhaps) of the data and the means of using it.

For this reason, attorneys should remember the difference between data backup and system backup. For most firms, the more thorough system backup should be preferred. Additionally, a practitioner who backs up but does not use adequate virus protection is inviting trouble. Many viruses corrupt all the data on the hard drives they infect. An example of this is the Klez virus.

Therefore it is critical to make sure no viruses are on the systems before running backups. Note that the best method to scan for viruses is not to do a full system scan with your current antivirus software, even if it is a recent version that automatically visits Web sites that are maintained by the makers of the software and downloads the latest inoculations. Instead, the virus scan should be run online.

Online scanning is a new virus scanning technique. This method provides a more comprehensive scan, in that it does not rely on the antivirus software that is installed on the local computer’s hard drive—which may be installed incorrectly, corrupted, or out-of-date. For an example of an online scan, users can go to www.sarc.com and click on Free Online Virus and Security Check.

Hardware Options

Zip drives once were the most familiar method of data backup, but by today’s standards they have limited speed and storage capacity. Today, CD burners have replaced the Zip drive as the standard data backup method. The cost to implement a data backup system with a CD burner is minimal, because most computers already have a burner (and if yours does not, they are no longer expensive), and blank CDs are quite cheap. The limitation of CD burners is that they cannot perform system backups, because they do not have enough disk space. The common remaining alternatives that can perform system backups are external hard drives and off-site storage.

Currently, the preferred method for small firms with limited technical knowledge is to use an external or removable hard drive for each computer that contains vital data. This device, coupled with software that copies information from one drive...
to another (Norton Ghost is an example), covers data and system backups and is recommended for firms of small to medium size. Larger firms, firms with especially valuable data, and firms staffed by people who cannot or will not keep their backup system up-to-date should consider off-site, managed storage solutions.

Tapes remain a popular backup method for network administrators performing on-site backups, because the storage capacity of tapes greatly exceeds Zip drives or CDs. Tapes are relatively inexpensive, so administrators can keep a fairly large number of tapes in rotation. This method is particularly efficient if a virus infects a firm’s system, because the administrator can restore the system to a time that predates the infection. Tapes are less easy to use, however, than separate hard drives. Another large-capacity, removable storage method is the DVD burner. This option is still rather uncommon, but it may become the preferred backup medium for most small firms because of its large storage capabilities.

**Backing Up with Windows**

For many small and solo law firms, a workable data backup and storage system will consist of Windows and a removable hard drive. To use this system, purchase and install a removable or external hard drive. Make sure the drive is formatted and ready for data storage. When the drive is ready, follow this path in Windows: Start, Programs, Accessories, System Tools, Backup. Begin with the backup wizard. If you have installed a removable hard drive that is larger than your internal one, choose Backup Everything on My Computer. Assign a name to the backup (this name can be the date of the backup) and use the Browse button to point the system to the removable hard drive. Then choose Finish. This method will back up everything—all system data and critical data. If the computer’s internal hard drive fails, the whole system can be recovered by running the Windows backup program again. To do so, choose the restore wizard and follow the directions. As with all backup methods, it is advisable to practice the procedure before having to perform it in a real emergency.

If you do not have a removable hard drive, another method is to use Windows backup and a working CD burner. No system backup is possible with this method, but you can create copies of your data. Begin by labeling a blank, burnable CD as Critical Data Backup. Add the date and make sure the CD is ready in the burner drive. Launch your CD burning software, make sure your burnable CD speed matches the speed of your burner, and configure the settings so that the computer will recognize and add to the blank CD that has been formatted as a separate drive on your system. Go to Windows backup and choose Backup Selected Files. Check those folders that contain critical data and choose Next. In the next screen, choose Browse and point the software to the drive you previously configured. Then click Finish.

Note that the main screen for Windows backup (which appears behind the wizard dialogue box) provides an easy, automated feature that allows users to schedule daily, weekly, or monthly backups. Click on the Schedules tab and select Add a Job at the bottom right. Follow the wizard to establish dates and times for backups.

These two methods—complete system backups with an external hard drive and critical data backups with a CD burner—can be used together, and they are the current standard for the needs of small firms. Remember that there are other devices that may need backups, such as Palm and pocket PC devices, and establish a system for making, filing, and testing your backup media. Data management is critical for the legal professional who is dependent on a computer, and with an effective backup system, your firm will be in a safe position if a critical system failure should occur.
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WEB SITES

The HIV Waiver

ON WEDNESDAY, JANUARY 22, the Barristers AIDS Legal Services Project will offer CLE training on the HIV waiver in immigration law. The training will discuss the adjustment of status for immigrants and the HIV exclusion, including the I-601 waiver and other supporting documents.

This event will be held at the LACBA/LEXIS Publishing Conference Center, 281 South Figueroa Street, Downtown. Parking at the Figueroa Courtyard Garage will be available for $7 with LACBA validation. On-site registration and the meal will begin at 11:30 A.M., with the program continuing from noon to 1:30 P.M. The event code number is 210TA22.

$15—all who attend
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The Basics of Commercial Leasing

ON WEDNESDAY, FEBRUARY 5, the General Real Estate Law Subsection of the Real Property Section will present a program on the basic elements of commercial leasing transactions. Speaker John Duffy also will describe in more detail the common issues that arise in these transactions. This program will be an excellent follow-up to the subsection’s program on the vocabulary of leasing, which was held in November 2002. The event will be held at the LACBA/LEXIS Publishing Conference Center, 281 South Figueroa Street, Downtown. Parking at the Figueroa Courtyard Garage will be available for $7 with LACBA validation. On-site registration will begin at 11:45 A.M. and lunch at noon, with the program continuing from 12:30 to 1:30 P.M. The event code number is 803LB05. CLE+Plus members free (meal not included). Prices below include meal.

$45—Real Property Section members
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$65—all others, including at-the-door registrants
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The Bench Meets the Bar

ON THURSDAY, JANUARY 30, the Litigation Section will present its annual luncheon for federal and state court judges and justices. At the luncheon, Judge Consuelo B. Marshall and Judge Robert A. Dukes will provide updates on issues of current concern to the courts, and the section will give its Seventh Annual Clerk of the Year Award to a federal and state courtroom clerk. The luncheon will take place at the Omni Los Angeles Hotel (formerly the Hotel Inter-Continental), 251 South Olive Street, Downtown. On-site registration will begin at 11:30 A.M. and lunch at noon, with the program continuing from 12:30 to 1:30 P.M. The event code number is 804LA30. CLE+Plus members free (meal not included). Judges and justices free, including meal. Prices below include meal.

$55—Litigation Section members
$550—Table of 10 (8 firm members and 2 judicial officers)
$75—all others
1 CLE hour
Battling through Life Sentences

Litigators need to identify and neutralize the “limiting beliefs” of clients and witnesses

The unseen can play a critical role in a trial. This fact has been underscored by recent speculation over whether juries have been affected by such public events as the terrorist attacks of September 11 or the epidemic of corporate skullduggery.

Often overlooked is another category of the unseen: the contents of the minds of parties and witnesses that form “limiting beliefs.” We all have limiting beliefs. From moments of fear or danger we experienced in childhood, we have formed largely irrevocable opinions about how life is and how we must act to ensure future safety. While the outward manifestations of these opinions may be quite visible to those around us, limiting beliefs remain largely buried and invisible. I call them “life sentences” because we can carry them for life.

However, a life sentence can be identified and commuted—if we know what it is and how to look for it. After more than two decades of picking juries and trying lawsuits, I have concluded that this area of trial preparation is easily as important as guessing whether exter nal events will affect jury results.

I became very interested in this concept many years ago when a client objected to cutting his hair for trial. His objection was so firm that I became quite interested and not a little concerned. After much prodding, he confided in me that his ears were deformed. When he finally showed them to me, I was astonished to see that his ears looked quite normal. I pointed this out to him in front of a mirror and asked him where he had gotten the idea that they were deformed.

He told me this intense feeling sprang from what he had experienced one day as a youngster when he burst into the family kitchen after school. His mother was apparently gossiping on the telephone and looked upset when she saw her son. Then he heard her say, “I have to hang up now. Billy has just come home, and little pitchers have big ears.” He had been kidded about the size of his ears on earlier occasions, so his mother’s comments were the last straw. He had long forgotten why he wore long hair but vigorously protected his right to do so. We both began to laugh, and my client ultimately agreed to cut his hair for trial.

As litigators, we do not have the time or wisdom to clear up life sentences for prospective jurors (although we can reject them if we suspect they carry life sentences that will work against our clients). Therefore, we must turn our attention to our clients and to the witnesses we intend to call and to be on the lookout for their life sentences. Common life sentences to watch for include:

- **For me to succeed, disaster must be at hand.** Only when being dragged up the steps of the gallows does this client finally call a lawyer. Why did the client wait? What causes this kind of eleventh-hour behavior? How is such behavior likely to effect the client’s case and ability to prepare properly for trial? This life sentence must be dismantled, or you will inevitably have a client who comes in at the last minute with “suddenly discovered” evidence or new witnesses that require revamping the entire trial strategy.

- **I don’t want the money.** This life sentence is impoverishing to both the client and the lawyer. It can stem from a childhood notion that people with money are defective, greedy, untrustworthy, or unattractive. A variation on this life sentence is the idea that since I am “bad,” I do not deserve abundance in life. These individuals go to court because they have lost money through a silly investment or have been unjustly fired, but they will inexplicably shoot themselves in the foot in front of a jury.

- **You didn’t ask.** You have to pull teeth to get vital information out of this client. Issues remain unexpressed, objections are unstated, feelings and vital facts are buried. The resultant misunderstanding makes the client’s relationships, including those with counsel, terribly unsatisfying. The fact that the client knows he or she should disclose everything has no impact. Even facts would place the client in a better light and would generally help resolve the case are withheld.

Be aware that when a life sentence is driving a client’s litigation, the client can “succeed” without actually winning at trial. Just bringing the litigation or having a deposition taken or telling a threadbare story or an oft-told lie to the jury is all the client really wants. Such cases are the hardest to handle. They are most easily spotted when you get the feeling that a client wants nothing so much as his or her day in court. As a professional, make sure your client’s story resonates with you. If it does not, a life sentence may be lurking in the background, and the results will be quite disappointing. Remember as well that our duty to our clients is broader than the instant litigation; it also includes a duty to keep clients out of litigation. Being alert to life sentences can be a major tool in fulfilling that duty.
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