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Mr. Gleitman has practiced sophisticated estate planning for 26 years, specializing for more than 14 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 52 estate planning issues to the IRS for private letter ruling requests; the IRS has granted him favorable rulings on all 52 requests. Twenty-three of those rulings were on sophisticated asset protection planning strategies.

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he past year was a very solid one for real estate practitioners. While a number of commentators expressed caution with respect to the real estate market and indicated signs of irrational exuberance, there were plenty of participants in the market who went forth with major sales, acquisitions, construction, development, leasing, and financing transactions.

As expected, real estate lawyers navigated their way through the complications of assisting clients to assemble the requisite ingredients in order to successfully close their transactions. As usual, many lawyers had to implement creative solutions in order to close those deals. These realities will continue. Moreover, new sectors or niches have emerged within the realm of real estate practice that have been drawing a great deal of attention from the real estate industry, including development in Indian lands, transfers and acquisition of tenancy-in-common interests in large projects, and condominium conversions of a broad range of property types, such as residential, hotel, industrial, and even parking spaces. This mixture of old and new contribute to making real estate practice a vibrant and growing field.

Real estate financing is among the core areas of real estate practice. As long as there are borrowers who fail to repay their debts, there will be a tension between a lender’s desire to have a guarantor in place as additional collateral for the repayment of the loan and for borrowers and their affiliates to do away with the need for personal liability for loans when they believe that the lender is adequately secured. Guaranty issues arise not only in financing transactions but in a host of real estate transactions in which one party is attempting to obtain some assurances that the other party will perform its obligations, whether under a lease or construction agreement. So while suretyship law may not be considered “dirt law,” the fact is that real estate lawyers must understand its concepts. This is an example of the interdisciplinary nature of real estate practice. The lineup of articles for this 21st annual Real Estate Law issue includes a discussion of the historical background of suretyship issues in California and how some of these guaranty principles may be applied in the context of special purpose entities, which are the structure of choice for a great many commercial lenders.

Another core area in real estate practice is leasing work. There seems to be no shortage of lease forms. Leasing issues may sometimes be given too little thought but, not surprisingly, the use provision in a lease can lead to a number of significant issues that affect the enforcement of landlord and tenant rights.

Newer areas of interest in real estate practice involve issues surrounding transactions in Indian Country. Some have said that handling transactions in Indian Country is like working in a foreign country, and it is a fair analogy. Working within Indian Country requires an understanding of the sovereign rights of the tribe to regulate activities within its lands. This affects the very right of tribal members to transfer title to property and the right of tribes and their members to enter into binding contracts. There is an additional overlay because many agreements with tribes require the approval of the federal government. Another challenge also arises from the sovereign immunity of the tribe. Absent a very clear waiver, the tribe, including its subordinate business entities, cannot be sued. These issues are explored in more detail in this month’s cover story on real estate transactions in California’s Indian Country.

We are very pleased with this special issue and hope you enjoy reading it and incorporating some of its tips and information into your practices.

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Implied-in-Fact Contracts in the Entertainment Industry

AFTER MONTHS OR YEARS SLAVING AWAY on a screenplay, a writer is able to reach a well-known studio executive, who is far too busy to actually read the script but asks the writer to submit a summary, or treatment. After submitting the treatment, the writer is invited to meet with the executive to pitch the idea. The executive passes, but later the writer reads in a newspaper that this very idea is being developed into a motion picture. Did the submission of the treatment and the pitch create an implied-in-fact contract with the studio to pay the writer for the idea?

In cases like this, the most commonly used causes of action to protect writers’ ideas in state courts are the breach of implied-in-fact contract and breach of confidence. Fifty years ago, the California Supreme Court recognized in Desny v. Wilder1 that although an idea is not property subject to exclusive ownership “it may be of … value to the person to whom it is disclosed. An idea may constitute adequate consideration in … a binding contract even if the idea is not novel.”2 An idea may be valuable merely because it is pitched at an opportune time.3 In 1975, the court acknowledged that California law also recognized breach of confidence.4

The primary means of selling ideas in the field of film and television is the pitch. Studios and networks have an enormous demand for new product, especially in television, where there has been a proliferation of networks in the past 20 years. As a consequence, film and television executives encourage writers to meet with them to pitch ideas. It is extremely rare for there to be a written contract in place at the time of a pitch.

To prove the formation and breach of this implied agreement, it must be shown that 1) the plaintiff possessed an idea, 2) it was disclosed to the offeree for sale, 3) under all the circumstances attending disclosure it can be concluded that the offeree voluntarily accepted the disclosure knowing the conditions on which it was tendered, 4) the offeree accepted the disclosure and thereby impliedly agreed to pay for any concepts it might use from the idea, 5) the idea was actually used by the offeree, and 6) the idea had a reasonable value, which is to be calculated.5 The first thing for an attorney to consider is what the specific idea was and how it was submitted. Examine the treatment, the screenplay, and how the treatment was sent to the studio executive. Under California law, the studio’s actual use of an idea may be inferred if it can be shown that the pitched idea is sufficiently similar to the movie or show being produced.6

In California, “access” is proven if one is able to show the person credited with creating the movie “had an opportunity to view or to copy the plaintiff’s work.”7 If the offeree is “an individual in a position to provide suggestions or comments…a supervisory employee,” or an employee within the unit from which the defendant’s work was developed, sufficient access is shown.8 Thus, an attorney representing a writer who alleges idea theft will have to establish that an executive had access to the idea by receipt of the treatment or information conveyed during a pitch meeting.9

Once access is established, the next step is to prove that the studio’s movie and the writer’s idea are similar. Whether two works are similar is determined “upon the impression received by the average reasonable man.”10 The leading case in California on this subject is Fink v. Goodson-Todman Enterprises, Ltd. In Fink, the court made it clear that the requisite similarity is less than in a copyright case. The similarity must be as “to a material element or qualitatively important part.”11 The “material element could range from a mere basic theme up to an extensively elaborated idea.”12

Finally, the writer will have to prove that the idea has value. However, it is not necessary to establish that compensation was ever discussed when the treatment was submitted.13 Discussion of compensation may be relevant to a cause of action for breach of express contract, but it is not relevant when the claim is breach of implied-in-fact contract. The formation of such an agreement is determined by the conduct of the parties, not their words.14

If the writer establishes access and the requisite degree of similarity it is likely he or she can state a cause of action. However, studios fight these cases very aggressively and at great cost to the writer. Typically, no matter how strong the case may appear, settlements are rarely achieved at an early stage.

The most commonly used causes of action in state courts are the breach of implied-in-fact contract and breach of confidence.

1 Desny v. Wilder, 46 Cal. 2d 715 (1956).
8 Id. at 1357.
10 Fink, 9 Cal. App. 3d at 1008.
11 Id. at 1008 n.15.

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FEW LEGAL TASKS are more underappreciated than the drafting of the various types of partnership agreements: partnerships, limited partnerships, and limited liability companies. The task of drafting partnership agreements, whether for real estate partnerships or for other partnerships, can test the skills of even the most proficient real estate or corporate practitioner, estate planner, or partnership tax lawyer. General-purpose form partnership agreements typically are defective. Efficient drafting practices, which emphasize cost-effectiveness over quality, only further compound the deficiencies.

A partnership agreement easily can go awry. A seemingly simple partnership agreement can encroach on complex issues of tax law, partnership law, fiduciary law, or real estate law. Many drafters fail to recognize sophisticated problems and danger areas. Partnership agreements too often suffer from the arrogance, complacency, incompetence, false economy, and inattention to detail of drafters. The question is not so much whether the standard form real estate partnership agreement will break down in practice but rather how much stress it can withstand before it breaks down. Defective partnership agreements can create serious economic problems. This can lead to litigation or to errors and omissions problems for drafters and their firms. A frequent problem is that, at the liquidation of the partnership, the partnership agreement provides for a cash distribution scheme different from what one or more partners expect. One partner frequently undertakes or wishes to undertake actions that could breach fiduciary duties owed to another partner or to the partnership.

While a full treatment of the issues raised in drafting partnership agreements would be treatise length, it is helpful to identify some of the most common deficiencies in real estate partnership agreements. Drafters need to learn more about the applicable laws in these areas, or perhaps to call in more sophisticated reinforcements.

As a first step, the drafter must choose the jurisdiction in which to form a partnership. California attorneys may feel a parochial interest in forming partnerships under California law. Other practitioners may be more comfortable forming partnerships under Delaware law or perhaps Maryland law. Underwriters of securitized debt may require partnership issuers of securitized debt to be formed under Delaware law. Many partnerships are formed under Nevada law. The partnership could also be formed under the law of the jurisdiction in which the partnership will have its principal place of business or in the jurisdiction in which it will conduct its principal operations.

No solution is correct for all partnerships. It is important, however, that the drafter understand the partnership laws of the jurisdiction in which the partnership is formed. It is easy to become lost in subtleties of local law if the drafter forms partnerships under the laws of many jurisdictions. Some practitioners imagine that they will achieve state tax planning advantages by forming a partnership under the laws of a specific jurisdiction. Typically, however, this will not be the case.

Delaware law can offer some advantages. The state has developed the largest and most robust body of case law on partnerships. The Delaware Chancery Court is familiar with handling business disputes. It avoids jury trials, which may be available in other states. Delaware law is flexible in permitting partnership agreements to waive or to define fiduciary duties and on remedies to address defaults in capital contributions and other breaches of a partnership agreement. Delaware law also permits series partnerships with limited liability among the various series of assets of the partnership. Delaware permits quick filing by facsimile. In addition, the merger of entities can be more efficient if all the entities are formed under Delaware law. Finally, practitioners in different states are more likely to be familiar with Delaware law governing partnerships than they are with the laws of other jurisdictions not their own.

Another initial issue is to define the purposes of the partnership to limit the scope of its business. The purposes provision in the partnership agreement, for example, can be used to force dissolution of a partnership upon the sale of an apartment project and to prevent a like-kind exchange of the partnership’s assets, in appropriate cir-

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cumstances. The purpose perhaps should be sufficiently flexible to permit a like-kind exchange if the client desires to undertake an exchange in the future. Consider limiting the purpose of an investment partnership, in appropriate circumstances, to investment activities in order to prevent subdivision and sale of real property or perhaps conversion of apartments to condominiums. It is also important to include special limitations on the activities of the partnership consistent with the nature of the client if it is a tax-exempt organization or a real estate investment trust.  

Contributions to the Partnership  

Real estate partnerships often are formed with in-kind capital contributions of property by one or more partners. In such cases, the partnership agreement should contain practically all the provisions of a well-drafted purchase and sale agreement (warranties and representations, closing conditions, prorations, title insurance, etc.). A long-form purchase and sale agreement typically is a good starting point in drafting the partnership agreement provisions governing in-kind capital contributions. These terms can be incorporated into the partnership agreement or a separate capital contribution agreement. Drafters should also consider the possibility that the contributor will have to make cash payments to satisfy breached warranties and should clarify the intended tax and capital account treatment of these warranty payments.

A special tax law governs allocations of future depreciation and gain or loss with respect to contributed property in situations in which there is a variation between the fair market value on the date of contribution and the adjusted tax basis. The partnership agreement should select the methodology that the partnership will use to apply these tax requirements. The partnership agreement should consider how these provisions will apply if the property is contributed further to a subsidiary partnership, or whether such a contribution should even be permitted. Furthermore, income and loss allocations should be adjusted to take into account this special tax law.

Rules concerning tax allocations with respect to contributed property typically apply on an asset-by-asset basis. Land and improvements are treated as separate assets for this purpose. Different improvements (such as different buildings) may be different assets for this purpose. The partnership agreement (or a separate contribution agreement) should schedule the agreed fair market value and adjusted basis of each contributed asset, separating land from improvements. The partnership agreement might contain a lock-in provision that prohibits the partnership from selling contributed property during a defined period after the date of contribution. Lock-in provisions often contain exceptions that permit partnerships to exchange the contributed property in a non-taxable exchange or to sell the contributed property in a taxable transaction if the partnership indemnifies the contributing partner for the resulting tax liability. These indemnification provisions are long, detailed, and complex. In the absence of these provisions, if the partnership sells contributed property, the contributor may suffer a substantial tax liability, which can far exceed cash distributions to that party.

Contributions of property to the partnership also create issues under tax rules governing disguised sales of property or disguised sales of partnership interests. A well-drafted partnership agreement should contain a matrix of partnership covenants designed to avoid disguised sale treatment. These covenants, if drafted correctly, could ensure that distributions will meet safe harbor requirements under disguised sale rules. Partnership covenants, for example, could prohibit distributions of contributed property to another partner within a two-year safe harbor period, consistent with applicable partnership regulations.

Partners often need minimum shares of partnership liabilities in order to avoid recognition of gain because of relief of contributed liabilities or reduction of at-risk amounts under IRC Section 465. Covenants in the partnership agreement often obligate the partnership to ensure that a contributing partner will have a sufficient share of partnership liabilities so as not to suffer gain because of liability relief or at-risk recapture. Partners often enter into a separate agreement with a partnership in order to ensure that minimum amounts of liabilities will be allocated to the partners and to ensure avoidance of gain because of liability relief or at-risk recapture.

Yet another obscure tax provision can affect gain or loss associated with property contributed to the partnership by a partner. IRC Section 724 locks in unrealized receivables and inventory items as ordinary income. The lock-in period for unrealized receivables is permanent, while the period for inventory items is five years. Section 724 also provides that loss recognized by a partnership with respect to contributed capital loss property will be locked in as a capital loss in the partnership’s hands. This lock-in lasts for five years. Drafters should therefore consider including certain representations in the partnership agreement to address the character of contributed assets.

Drafters also need to be cautious in drafting a partnership agreement for a partnership that is partially or wholly capitalized with stocks and securities. Many advisers are surprised to learn that a transfer of property, including a transfer of real property, to a partnership that would be treated as an investment company if it were a corporation, is usually a taxable transaction. This frequently arises with transfers to family partnerships that are principally capitalized with stocks and securities. The rules regarding in-kind capital contributions, as well as their application, are extremely complicated. Drafters should seek assistance from competent tax professionals to help them navigate through the issues raised by these rules, such as the tax liability of contributions to investment companies.

When the initial partnership contribution is in the form of cash, the drafting provisions should be less complicated than for in-kind contributions. The partnership agreement should define precisely the form in which cash will be contributed (for example, by wire transfer of federal funds) as well as the date by which capital contributions are required to be made. Proposed Treasury Regulations concerning the disguised sales of partnership interests must also be consulted. (A disguised sale may occur when the partnership assumes liabilities of the property or makes a distribution to a contributing partner.) Drafters should also consider a matrix of covenants in the partnership agreement that addresses and diminishes the risks of a disguised sale of a partnership interest to a contributing partner. These covenants can ensure that distributions will meet safe harbor requirements under disguised sale rules.

Partnership agreements often include provisions concerning additional capital contributions. These provisions should clarify who may authorize the call for additional capital, what limits govern the amount of additional capital that partners can be required to contribute, whether additional capital contributions are required or discretionary, what procedures are required for the capital call, when additional capital contributions are due, and in what form the cash will be contributed.

To address defaults in additional capital contributions, partnership agreements may incorporate elaborate provisions that may lead to the dilution or superdilution of the partnership interest of a defaulting partner, among other things. These provisions often break down in several areas, and some advisers prefer not to incorporate them at all. They argue that the partnership interest of a defaulting partner should be retired for payments or forfeited by the defaulting partner.

Dilution provisions typically increase the partnership interest of the partner making a capital contribution on behalf of a defaulting partner while decreasing the partnership inter-
est of the defaulting partner. The provisions must clearly indicate whether the dilution provision resets and readjusts interests both in profits/losses and in capital accounts. The dilution provision must properly coordinate with all the special distribution and allocation provisions in the partnership agreement.

A dilution provision that resets and readjusts capital accounts may have undetermined tax consequences that could create taxable income to the partner to whom capital is shifted. It may make sense to shift an interest in profits to the contributing partner, but not to shift the interest in losses. It also may not make sense to transfer a negative capital account to a partner making a defaulted capital contribution of another partner. It may be important to take into account special allocations and income chargebacks (including the minimum gain chargeback) in drafting the dilution clause. A provision in the partnership agreement requiring a substantial chargeback of prior losses may vitiate the effects of a dilution provision. A shift of a portion of a defaulting partner's negative capital account to a contributing partner may not make economic sense. Drafters should test various financial scenarios to ensure that the dilution provision produces sensible economic results.

Dilution provisions often penalize a defaulting partner for defaulting on his or her additional capital contribution obligation. In designing a provision to coerce the partner to satisfy a capital contribution obligation, remember that some courts may be reluctant to enforce punitive provisions especially if the defaulting partner is in bankruptcy. Although some state partnership acts permit penalty provisions, the status of penalty provisions approved by these acts under bankruptcy law or under laws of other states is still to be determined.

A substantial body of literature considers the tax effects of receiving a partnership interest (particularly a profits interest) as consideration for the partner's admission. The proposed regulations permit the service provider's income to be measured under the time of the service provider's admission. This safe harbor provides that the measure of the service provider's income is the amount that the service partner would receive in the liquidation. To successfully elect this safe harbor, the partnership agreement should contain provisions that are legally binding on all partners, stating that 1) the partnership is authorized and directed to elect the safe harbor, and 2) the partnership and each of its partners (including any person to whom a partnership interest is transferred in connection with the performance of services) agree to comply with all requirements of the safe harbor with respect to all partnership interests transferred in connection with the performance of services while the election remains effective.

The measure of the service provider's income outside the safe harbor may be based on the excess of the fair market value of the partnership interest over any amount that the partner may pay for that interest. This can potentially apply in situations where the service provider contributes both cash and services as consideration for the partner's interest in the partnership. Many partnerships involve mixed contributions of capital and services. In this case, the election of liquidation valuation in the partnership agreement is particularly important. This election should be included whenever a partner contributes services to a partnership. (At least it will be important if the proposed regulations are finalized as they now are drafted.)

The drafter of a partnership agreement has a choice between distributing proceeds of liquidation of partnership assets in accordance with capital account balances at the end of the partnership's life and distributing the proceeds in accordance with percentages (perhaps percentages in defined tiers). Treasury Regulations concerning partnership allocations favor liquidation in accordance with capital accounts. Experience, nevertheless, has shown that many drafter's income and loss allocations are careless. Capital accounts sometimes can depart materially from the intended deal. Regardless of the drafter's proficiency, he or she should work closely with the partnership's accountants in testing various financial scenarios to ensure that allocation provisions produce capital accounts consistent with the economic deal.

The drafter may determine that the partnership should liquidate in accordance with defined percentages or tiers of percentages. This approach may make it more difficult to determine how taxable income and losses will be allocated annually. Liquidating by defined percentages or tiers of percentages, however, usually produces a more reliable economic result than liquidation by capital accounts. Special tax rules, however, make it difficult for pension plans to invest in partnerships that do not liquidate in accordance with capital accounts.

While drafting cash allocation provisions is, itself, an exceedingly complex undertaking, some basic principles should be kept in mind. Simple, single-tier percentage distribution provisions are not difficult to draft (e.g., 25 percent to Elvira, 75 percent to Rapunzel). Nevertheless, the drafter should clarify not only how distributions are divided between general and limited partners, but also how distributions are divided within each of these two groups. The partnership interests transferred in connection with the service partner's admission are taxed differently from those already allocated in the partnership. Special tax rules, however, make it difficult for pension plans to invest in partnerships that do not liquidate in accordance with capital accounts.

A common distribution provision provides for a preferred percentage return on invested capital. Important points that need to be addressed in the provisions include:

- What contributions are included in invested capital.
- What distributions reduce invested capital.
- On what date capital is treated as invested.
- On what date capital is treated as recovered.
- The interest rate of the return.
- Whether the return accumulates if there are not funds available to pay the return annually.
- Whether the return compounds.
- How often the return compounds.
- The date the return compounds.
- The computational year (such as a deemed year of twelve 30-day computational months or a calendar year of 365/366 days).
- Whether arrearages in the return are paid on liquidation if they are not paid out of cash from operations.

Another important distribution provision provides for special priority distributions to permit partners to pay taxes on their shares of partnership income, so tax distribution provisions need to be tested to see if they will affect the economics of the deal. For example, a tax distribution provision was at the heart of the litigation in Interactivecorp. v. Vivendi Universal, S.A. In this case, the Delaware Chancery Court held that approximately $600 million in tax payments to a party under a tax distribution provision did
not reduce other cash distributions to the partner under the partnership agreement between Vivendi Universal and USA Interactive.24

Avoid tax distribution provisions that merely provide that the partnership will make a distribution to a partner in an amount equal to his or her tax liability from partnership income. These provisions are ambiguous. Better-drafted provisions typically are based on notional tax liability.23 These well-drafted tax distribution provisions can be complicated. Some of the issues that these provisions may address are:

- Notional combined federal and state tax rates.
- Different tax rates for income of different character (ordinary income, IRC Section 1250 recapture, capital gains, corporate dividends).
- Notional federal deduction for state tax.
- Quarterly cash distributions for estimated tax.
- Clawback of excess tax distributions if interim tax distributions exceed notional tax liability.
- Clawback of tax distributions if income in early years is followed by losses in later years.
- How tax distributions are recouped from other future distributions.
- Exclusion (or inclusion) of income specially allocated to a partner under tax rules concerning contributed property.
- Whether tax distributions are absolute distributions or whether they must be returned if they are not fully recouped from other distributions to the partner.

Tax reimbursement provisions typically should be based on the same notional tax rate for all partners, regardless of whether some partners are individuals and others are corporations, and regardless of whether some partners live in different states than others or move from one state to another.25

A distribution tier based on achieving a defined internal rate of return on net invested cash requires careful drafting. This includes careful definition of the mathematics of internal rate of return,26 recognition that a partner rarely will achieve precisely any given internal rate of return,27 and clear designation of when contributions and distributions are treated as paid. Inexperienced drafters should avoid internal rate of return provisions whenever possible.

Again, many financial scenarios need to be tested to ensure that the cash distribution provision works satisfactorily if the partnership agreement includes a cash distribution provision based on achieving a specified internal rate of return. Increases and decreases to the base against which the internal rate of return is computed need to be carefully defined. Preferred return provisions are sensitive to when cash is deemed contributed and when cash is deemed distributed, so it is important to specify the formula used for computing internal rate of return,28 the computational year, compounding frequency, and compounding dates. These provisions should also clarify how each distribution is divided among partners receiving the distribution.

Some agreements define “internal rate of return” merely in terms of the result of a spreadsheet program. This sloppy drafting practice could lead to ambiguities.29 The following should be considered when drafting cash flow distribution provisions:

- Separate income and loss allocations from cash flow distributions.
- Divide the cash flow distribution provision into three parts—operating cash flow, cash flow from capital events, and proceeds of liquidation.
- Coordinate the drafting of preferred returns and similar items that may be paid from either operating cash flow, cash flow attributable to capital events, or proceeds of liquidation.
- Draft cash flow distribution provisions before drafting allocations of profits and loss.
- Provide for liquidation in accordance with capital accounts only if a drafter competent in partnership allocations has drafted the allocations.
- Ensure that each tier of distributions not only specifies how much cash flow to allocate under the tier but also clearly states how cash flow under the tier is distributed among partners receiving distributions under the tier.
- Test financial examples to ensure that the allocations work.
- Coordinate the work with the partnership accountants to ensure they can understand the distribution and allocation provisions.

Federal tax law often requires tax withholding on distributions to foreign partners. State tax laws may require tax withholding on distributions to nonresidents or on nonresidents’ allocations of partnership income. A provision in the partnership agreement should authorize withholding on partner distributions. The partnership agreement also should treat required withholding that exceeds distributions to the partner as partner demand loans.

Allocations of Partnership Income and Losses

Allocations of partnership income and taxable loss should accord with partnership economics.31 Allocations typically adjust capital accounts so that each partner will receive the amount in his or her capital account on retirement or liquidation from the partnership. This applies regardless of whether the partnership agreement explicitly distributes the proceeds of liquidation in accordance with
capital accounts. These allocations must be drafted carefully so that capital accounts and cash distributions will agree and will “zero out” each partner’s capital account by the time of liquidation. Here, too, various financial scenarios should be tested to ensure that allocations are correct.32

Certain allocation provisions (such as the minimum gain chargeback) reflect special tax concerns that are embedded in tax regulations.33 The partners must understand these concepts, since they will affect their capital accounts and ultimately may affect how cash is distributed. A drafter who does not understand these concepts should seek help from someone who does.

The drafter also should understand the difference between cash distribution provisions and tax allocation provisions. Cash is green. Cash is spendable. Taxable income is not. Taxable income is reportable on a partner’s tax return. Taxable losses can reduce a partner’s tax liability.

Drafters need to take into account the possibility of “phantom gain” (which occurs when property is sold subject to a nonrecourse liability in excess of its tax basis, and thereby creates gain excess of net cash) in situations in which allocations of taxable income exceed distributions of cash flow. Substantial gain may be allocated to partners, while cash will go toward repayment of partnership liabilities or payment of partner capital contributions. Partnership agreements can include provisions that will mitigate the effects of tax liability without cash flow if they understand the consequences of “phantom gain.”

Provisions allocating taxable income and tax losses should be separate from those allocating cash distributions. It is not sufficient to provide that taxable income will be allocated in the same manner as cash distributions because doing so can result in the double return of capital contributions. Cash distributions include distributions returning invested cash, for which income allocations are not appropriate. A provision that merely allocates taxable income to follow cash distributions often will distort the economic deal as it allocates taxable income to partners receiving return of their capital investments. Furthermore, the timing of taxable income and cash distributions frequently will differ.

A partnership agreement for a real estate partnership typically will contain a series of allocation provisions mandated by regulations. These provisions include the minimum gain chargeback, partner minimum gain chargeback, qualified income offset, and allocation provisions for nonrecourse deductions and partner nonrecourse deductions. These provisions typically apply prior to other allocations. “Nonrecourse liabilities” are liabilities for which no partner has personal lia-
bility. The excess of nonrecourse liabilities over the adjusted basis of the collateral is referred to as minimum gain. “Nonrecourse deductions” are defined as the annual increase in minimum gain. The annual nonrecourse deductions correspond to the annual increase in nonrecourse liabilities over the adjusted tax basis of the security for these nonrecourse liabilities.

When minimum gain is reduced, such as on a sale of the collateral for nonrecourse liabilities, the “minimum gain chargeback” applies to allocate the income corresponding to the minimum gain to the partners who received prior allocations of nonrecourse deductions. This highest-priority allocation occurs prior to any other allocation under the partnership agreement.

“Partner nonrecourse liabilities” are nonrecourse liabilities wherein a partner bears the economic risk of loss of the liabilities.34 Partner nonrecourse deductions correspond to nonrecourse deductions, but partner nonrecourse deductions apply to partner nonrecourse debt. The “partner minimum gain chargeback” similarly applies to reductions in partner nonrecourse debt minimum gain. The partner minimum gain chargeback allocates income to partners to whom partner nonrecourse deductions were previously allocated in situations in which partner nonrecourse debt minimum gain is reduced, such as on the sale of the collateral.

The qualified income offset is a technical tax allocation provision that rarely applies, but normally should be included in a real estate partnership agreement. This provision will create special income allocations in certain circumstances in which a partner has a deficit balance in his or her capital account (in excess of any limited dollar amount of the deficit balance that the partner is obligated to restore) as of the end of the partnership taxable year. The qualified income offset will apply to the extent that the deficit balance in a partner’s capital account is subject to unexpected 1) adjustments that are reasonably expected to be made as of the end of the year to the partner’s capital account for depletion allowances with respect to oil and gas properties of the partnership, 2) allocations of loss and deductions that are reasonably expected to be made as of the end of the year to the partner pursuant to the family partnership rules, partnership varying interest rules, and collapsible partnership rules, and 3) distributions that are reasonably expected to be made as of the end of the year to the partner to the extent they exceed offsetting increases to the partner’s capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which the distributions reasonably are expected to be made.
Even advanced practitioners often have difficulty drafting the minimum gain chargeback, partner minimum gain chargeback, qualified income offset, and allocation provisions for nonrecourse deductions and partner nonrecourse deductions. Consider drafting these provisions by cross-referencing the applicable partnership Treasury Regulations.35

Beyond these special regulatory allocations, partnership allocations will reflect the underlying economics of the partnership. Allocations of net income and net losses will be reflected in partnership capital accounts. Partners should receive the amount in their capital accounts upon termination of the partnership, regardless of whether the partnership explicitly distributes the proceeds of liquidation in accordance with partnership capital accounts.

Complicated partnership allocations normally are the province of an experienced tax lawyer. Financial scenarios that forecast how the allocations would work under a variety of economic assumptions should be tested with the cooperation of the partnership accountants to confirm that the allocations work and to confirm that they are understandable. Drafters who are unsure of their allocations should consider providing that the partnership will liquidate in accordance with specified percentages or tiers of percentages, rather than in accordance with partners’ capital accounts.

Some agreements allocate gross income and gross deductions, but these agreements are difficult to draft. It usually makes more sense to allocate net income and net losses, concepts that need to be carefully defined. Some agreements allocate net income and net losses as computed in accordance with Generally Accepted Accounting Principles. Other agreements allocate net taxable income and net taxable losses. It typically makes the most sense to allocate net income and net loss as computed in accordance with the Treasury Regulations governing capital accounts.36 Net income and net loss allocated in such a way are often referred to as “book income” and “book loss,” respectively. A carefully drafted partnership agreement might adjust book income and book loss by excluding items that are allocated under special allocations provisions, such as the minimum gain chargeback, partner minimum gain chargeback, nonrecourse deductions, partner nonrecourse deductions, and other special allocations provisions.

Drafting income allocations corresponding to a preferred return typically requires allocating income that parallels the accrual (rather than the distribution) of the preferred return. Drafting income allocations corresponding to an internal rate of return should be left to an expert drafter.37 Merely provid-
ing income allocations for preferred returns and returns based on internal rate of return that allocate taxable income to a partner until he or she has been paid the required return will normally produce unsatisfactory economic results.

Special rules apply to allocations in partnership agreements in situations in which certain qualified organizations are direct or indirect partners. Allocations for these partnership agreements are subject to a series of complex "fractions rules" that must be satisfied in order for the otherwise tax-exempt entity to avoid taxable income because of partnership liabilities. Drafting partnership allocations for these partnerships is a complex task that should be left to specialists.

No matter its quality, no form agreement can substitute for thought, experience, and careful lawyering. As in any area of the law, practitioners need to be mindful of their own limitations in skill and knowledge and seek help when needed. Above all, draft like a professional, not like a mere scrivener.

1 Drafters should consider many tax issues in addition to those discussed in this article. For example, they should become familiar with the family partnership rules of I.R.C. §704(e) and the special valuation rules of I.R.C. §2701. Drafters also should consider the effects of a series of disguised sales rules variously under I.R.C. §§704(c)(1)(B), 707(a)(2)(B), and 737. Drafters are cautioned to consider the investment company rules of I.R.C. §721(b) that can cause contributions to certain partnerships to be fully taxable. These rules particularly should be considered if a partnership includes securities as assets.

2 Drafters also should consider the form of entity: general partnership, limited partnership, limited liability partnership, or limited liability company. The partnership's decision process should include tax treatment under local law.

3 Some states will impose franchise or other taxes on partnerships or limited liability companies. For example, California imposes a minimum tax on limited partnerships and a fee on limited liability companies, and Texas imposes a franchise tax on limited liability companies.

4 Series partnerships and limited liability companies are perhaps the most revolutionary entity available. Series partnerships permit different classes of interests associated with different classes of assets. The economic interests can be varied across classes. The series can be established so that liabilities of one series will not infect assets of another series.

5 Sometimes the partnership agreement will be drafted to permit an exchange despite the objections of one of the partners. See Trump v. Cheng, Index No. 602877/05 (N.Y. Sup. Ct., Sept. 14, 2005) (Donald Trump failing in his argument that the partnership was not permitted to undertake an exchange of the former Penn Central railroad yards on the Hudson River waterfront for the Bank of America building in San Francisco).

6 These limitations, for example, might limit "dealer" activities that could attract the penalty tax under I.R.C. §857(b)(6) and might require that income constitute "rents from real property." A pension plan investor might insist on provisions in the partnership agreement that address liabilities-financed income. See I.R.C. §514(c)(9)(E).
abilities. These provisions typically involve “with and without” computations. They should set forth a mechanism for making the computations, such as designating a neutral accountant to make them.

Another alternative is to require that distributions be at least a given percentage of the partnership’s taxable income.

Drafters are discouraged from defining internal rates of return by referring to results of a spreadsheet program (such as Lotus 1-2-3 or Excel). Defining an internal rate of return in terms of the results of spreadsheet calculations may incorporate unwanted conventions (such as an unwanted computational year) and could create unwanted results in the case of software failure. The internal rate of return involves solving a high order polynomial. This usually is undertaken through an iterative search (using systematic trial and error, applying techniques of numerical analysis) on a calculator or computer.

For example, an additional $0.01 of cash distributed may take a partner from a 6.99997% internal rate return to a 7.00003% internal rate of return. A partner may never receive precisely a 7% internal rate of return. A tier defined in terms of “until X receives a 7% internal rate of return” may be problematic.

An elegantly drafted provision normally should eliminate imaginary number solutions to the internal rate of return.

Drafting income allocations is particularly challenging when cash distributions tiers are defined in terms of achieving a particular internal rate of return. Partnership agreements often technically allocate income offset to the tier providing for a distribution necessary to achieve a prescribed internal rate of return. This makes it difficult to know how much income to allocate corresponding to the tier providing for a distribution necessary to achieve a specified internal rate of return. The drafter may allocate too much income under the income tier corresponding distributions.

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Use Provisions in Commercial Leases

**THE USE PROVISION** in a commercial lease is a potential weapon in the hands of a landlord or a tenant. The landlord can seek to terminate the lease, obtain money damages, or enjoin the tenant from using the leased premises in a manner not called for in the use provision. The tenant may rely on the exclusive use provision to attempt to stop the landlord from leasing to another tenant for the same use. The tenant may also apply the use provision to relieve itself of rent obligations when a use is no longer possible. Litigation, generally, falls into two types of disputes: the construction of the restrictive covenant and whether the competing tenant’s anticipated or actual use is covered by that covenant. These disputes often overlap. In the vast majority of cases, the question of who wins in these disputes turns on drafting decisions that were made before the dispute arose.

Construction of the landlord’s restrictive use provisions is undertaken using general contract interpretation rules. Therefore, the terms must clearly restrict the landlord if the tenant is to prevent leasing to a competitor. For example, in *Strong v. Morrison*, the question was not the scope of the restrictive use provision (namely, that the lessee shall have the “exclusive grocery privilege in this market…”) but whether the offending tenant was violating the defendant’s exclusivity. In that case, because of the defendant’s “indefinite state of his own mind as to the exact limits of his exclusive privilege…it was certainly his duty to point out to the lessors the specific articles and give them an opportunity to correct the condition.” When he could not, he lost. On the other hand, courts have found that a “furniture store” precludes a competing seller of carpets, rugs, and linoleum, and a restriction against the sale of drugs, medicines, and cosmetics includes products that do not require a prescription.

Courts have also utilized the implied covenant of good faith and fair dealing to expand upon the express restrictions of the use provision, typically by expanding the restriction to real property not expressly covered by the lease:

A restrictive covenant, such as the grant of the exclusive mercantile rights to respondents, is not merely ornamental words, inserted to please the eye. It is a living expression of the grantor incorporated in a lease as a consideration for the lessee’s faithful performance. *Concomitant with such a covenant is the implied obligation of the lessor not to cancel the covenant or derogate from its force by so using his adjoining property as substantially to impair the lessee’s enjoyment of the leased premises.*

Similarly, a landlord could not build an addition to its shopping center and then lease space to a new tenant who was going to use the space in the same manner covered by a restrictive use provision.

Once a default is found with respect to the lessor’s duty to enforce the restrictive use provision, the question becomes what remedies are available to the tenant. If the restrictive use covenant runs to the entire consideration of the lease, then the tenant will be excused from further performance under the lease, including future payment of rent.

The landlord has a nondelegatable duty to uphold that use restriction. The landlord cannot meet its duty to comply with the restrictive use provision by delegating attempted resolution of the competing tenants’ claims to them. “It could not abrogate that obligation, or excuse itself from performance of that duty by seeking to delegate its performance to others, especially to the very persons from whose competition that promise was made for the protection of the plaintiffs.”

Of course, if tenants can agree upon a dividing line between their respective uses, the landlord can limit or eliminate its potential liability. Is the landlord given an opportunity to correct the problem before the tenant is excused from its obligations under the lease? In those situations in which the landlord is only indirectly at fault—that is, it did not instigate a competing use that conflicts with the restrictive use of the premises—then the landlord is “entitled to reasonable notice and time sufficient to enable it to acquire knowledge of the facts, to ascertain whether the condition could be corrected, and if possible to prevent a continued breach.” On the other hand, when the landlord directly violates the restrictive use provision by, for example, entering into a new lease that clearly competes with the restrictive use provision, “the contention that notice and reasonable opportunity to comply with the terms of the covenant are necessary to put the lessor in default, has been rejected.”

A last wrinkle to be considered is whether the tenant’s prior failure to pay rent excuses the landlord’s duty to enforce the restrictive use provision. The answer is yes and no. “Default by the lessee in payment of rentals does not waive the lessor’s performance of the restrictive covenant unless the lease provides expressly or by necessary implication that performance thereof depends upon the payment of rentals.” However, if the lessor opts to terminate the lease following the rental default, there is no further restrictive use obligation.

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The Tenant’s Duties

Landlords often seek to limit tenants’ use of the premises through permitted use provisions. The express provisions of the lease agreement are crucial to any dispute. Although a lease consists of contractual and real property components, it is interpreted like any other contract. In the absence of a specific limitation on the use of leased premises, the tenant may use the property “for any lawful purpose not materially different from that in which they are usually employed, to which they are adapted or for which they were constructed.” Indeed, Civil Code Section 1997.210(b) provides that “[u]nless the lease includes a restriction on use, a tenant’s rights under a lease include any reasonable use of leased property.”

Generally, however, “[r]easonable use restrictions are valid and enforceable.” Section 1997.210 of the Civil Code provides that, subject to certain limitations, a lease may include use restrictions. The Civil Code provides that these restrictions can include an absolute prohibition against change in use by the tenant, that a change in use is subject to an express standard or condition, and that a change in use is subject to the consent of the landlord. Any ambiguity in a restriction on use of leased property shall be construed in favor of unrestricted use.

Landlords often include a generalized use provision that precludes the tenant from violating applicable laws. Sachs v. Exxon Company, U.S.A. is an example of how the courts of appeal can give an expansive construction of the “compliance with law” provision, while Deutsch v. Phillips Petroleum Company shows how the courts can narrowly construe the scope of the provision. In Sachs, the landlords asked their tenants for permission to conduct tests at a service station that the tenants had leased from them for several years. The landlords advised the tenants that an environmental expert had told them that there was evidence of soil contamination on the property and that further investigation was needed. When the tenants refused the landlords access to the leased property to conduct those tests, the landlords filed a complaint seeking that right based upon the lease’s provision that the tenants would operate in compliance with law.

The trial court granted the defendant tenants’ motion for summary judgment, but the appellate court reversed, rejecting the tenants’ argument that the landlords must wait until the end of the lease term before taking any action. The appellate court relied upon the tenants’ duty to “comply with all ordinances and laws” and held that the contamination of which the landlords were concerned could support a cause of action under state or federal environmental protection laws. Therefore, because liability under state and federal law “may exist,” the landlords may be subject to liability, and therefore, according to the appellate court, the tenants had breached the applicable covenant.

In determining what remedies should be available to the landlords, the court first held that the assurance that the tenants would not violate any law “is of little benefit to the landlords if they are precluded from assuring themselves that no such violations are taking place, particularly in circumstances in which they reasonably suspect violations.” Since contamination which would give rise to a violation of environmental law is usually hidden from a layman’s view, the means by which a violation can be ascertained requires the use of expert investigation. Thus, good faith and fair dealing as respects the covenant of lawful activity requires a reasonable means by which the Sachs can assure themselves as to the status of environmental hazards which may be the result of the tenant’s activities.

The appellate court gave instructions that if upon remand the trial court determines that further investigation is appropriate, the investigation must be limited to what is reasonably necessary under the circumstances. “We raise this point because we wish to make it clear that the implied covenant we have recognized establishes an objective standard of performance; in the absence of an expressed agreement to the contrary, the Sachs have no right to insist upon satisfaction of any subjective standard of testing or investigation.”

In Deutsch, the appellate court did not allow a landlord to rely upon an expansive construction of a “compliance with law” provision to terminate a lease. The parties’ commercial lease of a gasoline service station provided that the tenant “shall conduct its business on the said demise premises in conformity with all State or Federal Statutes and Municipal Ordinances applicable thereto.” The landlord sought to evict the tenant based upon a final judgment in favor of the United States that found the tenant liable for federal and state antitrust violations. The Deutsch court recognized that “[i]illegal or unlawful activity may be made the basis of a termination of a leasehold by either statute…or express covenant,” but held that the “antitrust violation which is the basis of this suit is a violation of a statute which is directed to the conduct of defendant’s business rather than to the premises which are the subject of this lawsuit.” The court held that the “thrust of this covenant is directed to the functional use of the property.” In reaching its decision, the appellate court held that the purpose of the use provision relied upon by the landlord “is to protect the lessor’s interest in the demised premises by limiting the functional use of the property.” Further, “it serves as an additional assurance to the lessor that the lessee will utilize the demised premises in a manner conducive to the lessor’s interest so as to secure the continued payment of the rental obligations.” The antitrust violations did not, according to the court, go to the purposes of the use covenant. The court held that the result was consistent with Civil Code Section 1442, which “abolishes forfeitures,” requiring that forfeiture provisions are to be strictly construed against the party who asserts them.

Similarly, in Rowe v. Wells Fargo Realty Services, Inc., the landlords sought to use the “compliance with law” provision to terminate the lease after their attempt to force an increase in rental payments failed. The landlords sought to “reaffirm” certain building rules that they had not previously submitted to the tenant, including limitations on thermostat adjustments for heating and air conditioning. About one month later, the landlords then sent a Three-Day Notice to Quit based, in part, upon the tenant allegedly “repeatedly us[ing] the premises for unlawful purpose…by tampering with the plenum temperature control of the heating and air conditioning system of the property so as to cause the temperature within the premises to lower below the limit allowed by the Department of Energy….”

Before the landlords’ action went to trial, they took the matter off calendar. However, the tenant then moved for summary judgment. As in the Deutsch case, the court did not find that the tenant’s conduct constituted the type of unlawful conduct precluded by the use provision:

Here, [the tenant’s] alleged violation of the Department of Energy regulation does not threaten the physical safety of the property, nor is it the type of unlawful criminal activity which would stigmatize the premises. Further, [the landlords] have not alleged facts to indicate their continued receipt of rent.
was in any way impaired merely because [the tenant] reset the temperature on the premises.56

The appellate court then held that the landlords’ claim was meritorious on several levels. The court held that “[unless] the lease specifically limits the use of the property to a particular purpose, or that restriction is necessarily inferred from the language which is employed, the lease may not be forfeited on account of the mere use of the property for another purpose even though that be an illegal use prohibited by statute, for the reasons said forfeitures of leases are not favored by the law.”57 The court pointed out that the lease limits the use of the property to general office purposes and data processing and that was exactly the function for which the property was being used by the tenant.

An additional twist on the legality of use for the premises occurs when the sole use allowed for the premises becomes unlawful. When that use becomes unlawful, the courts have excused the tenant from further obligations under the lease. Such a situation occurred in the early part of the twentieth century when tenants who were required to use their leased premises for the sale of alcoholic beverages were faced with Prohibition.58 “[A] lease restrictive in its terms as to the business permitted to be done upon the premises becomes inoperative upon the event that the law shall prohibit the doing of that business.”59 In this situation, the trial court first looks to see if the restrictive use is permissive or mandatory, and, if mandatory, whether the governmental order or law makes the use unlawful.60

In addition to the application of “compliance with law” provisions, case law also has construed specific restrictive provisions with respect to the tenant’s use of the leased premises. For example, in Purity Stores, Ltd. v. Linda Mar Shopping Center, Inc.,61 the court had to determine whether the tenant’s use provision limiting its operation to the sale of groceries allowed the tenant to sell beer. Relying upon the parties’ predispute conduct, the appellate court found that the tenant’s permitted use provision did not include the sale of beer.62 In an irony not lost on the court, because the landlord’s restrictive use provision was similar to that of the tenant’s use provision, if the tenant had the right to sell beer, it also had the exclusive right to do so. Because the tenant admitted it did not have the exclusive right to sell beer (in fact, the tenant had allowed a liquor store to open and operate in the shopping center), the parties could not have understood that the tenant’s operation of a grocery store included the sale of beer.63

Use provisions are creatures of drafting and must be thoughtfully considered so as to conform to the parties’ understanding. Many disputes may be avoided if the drafters use specific definitions for the restricted and allowed uses of the parties.

1 Restrictions on the use of property can also arise in deeds transferring the fee interest in real property. See, e.g., Boughton v. Socony Mobil Oil Co., Inc., 231 Cal. App. 2d 188, 190 (1965) (Deed prohibiting the dispensing of petroleum products was enforceable.); Doo v. Packwood, 265 Cal. App. 2d 752, 756 (1968) (Deed prohibiting the retail sale of groceries was a legitimate restrictive covenant against competition.). Restrictions can also apply to subleasing and assignment. See, e.g., Pay ‘N Pak Stores, Inc. v. Superior Court, 210 Cal. App. 3d 1404, 1411 (1989). In addition, use restrictions can arise in reciprocal easement agreements; conditions, covenants, and restrictions; as well as exclusive use and/or restriction agreements tailored for the purpose of limiting use of the premises.


3 See Carr v. King, 24 Cal. App. 713, 722-23 (1914) (Landlord who was precluded from leasing to another for the same use was not stopped from selling the property to a competitor of the tenant.). But see Hudson Oil Co., Inc. v. Shortstop, 111 Cal. App. 3d 488, 497 (1980) (Because the buyer of a property knew that the seller was subject to a restrictive use of the property pursuant to a lease to the plaintiff, the court found that it could enforce the restrictive covenant against the buyer as an equitable servitude.).


5 Id. at 170.

6 Id. at 171.

7 Id.

By expressly precluding tenants from using the premises tenant and the exclusive use rights of another but also overlap between the permissive use provisions of one as to its restrictive use duties by not only avoiding the landlord or tenant should be responsible for the cost of environmental cleanup.

Sachs, 9 Cal. App. 4th at 1498.

Sachs, 9 Cal. App. 4th at 1499.


Id. at 588.

The original tenant was Tidewater Associated Oil Company, which had subsequently sold various properties, including approximately 3,250 service stations to Phillips Petroleum Company, including one in Encino. Shortly after the acquisition by Phillips, the United States filed an antitrust action against Phillips and Tidewater. Seven years later, the U.S. District Court held that Phillips’s acquisition of the Tidewater assets was a violation of the Clayton Act. That decision was affirmed by the U.S. Supreme Court. On the day that the Supreme Court affirmed the judgment, the plaintiff/landlord notified Phillips that the landlord was terminating the Encino service station lease based upon the “compliance with law” provision and the Clayton Act violation. Id. at 587-89.

Id. at 589.

Id. at 590.

Id. at 591.

Id. at 592.


The applicable use provision precluded the tenant from doing or permitting to be done “in or about the premises...anything which is prohibited by or will any way conflict with any law, statute, ordinance or governmental rule or regulation now enforced or which may hereafter be enacted or promulgated...Lessees shall not...use or allow the premises to be used for any improper, immoral, unlawful, or objectionable purpose...” Id. at 313.

Id. at 315.

Id.

Id. at 318 (footnote omitted).

Id. (citations omitted).


Id. at 309.

See Security Trust & Sav. Bank v. Claussen, 44 Cal. App. 735, 737 (1919) (Language that the premises were to be “used for the purpose of conducting and carrying on the business pertaining to a general retail liquor establishment...” is permissive not restrictive.).


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Real estate lawyers advising clients who seek to conduct business with California Indian tribes not only need to employ the usual legal analyses applicable to any transaction but also must consider a notable added dimension. Federal law treats each Indian tribe as a sovereign government. The U.S. Supreme Court refers to Indian tribes as “domestic dependent nations” that retain an inherent sovereignty that predates the U.S. Constitution. Consequently, an entire body of law governing transactions with Indian tribes and their members has developed.

In conducting business with tribal governments or individual members of the various Indian tribes, practitioners must remember that Indian law principles only apply to real estate transactions involving “Indian Country.” If the transaction involves real estate transactions with individual Indians for lands that do not qualify as Indian Country, the standard state laws governing these transactions will apply. However, if the real estate transaction involves a tribal government, then certain federal doctrines will play a role in shaping the transaction, regardless of whether the land in question is located within Indian Country.

Federal law preempts state law in the area of real estate transactions within Indian Country. A corollary to the sovereign status of Indian tribes and federal preemption is the principle that the civil laws of the State of California generally do not apply within Indian Country. Furthermore, federal law expressly requires federal government approval of contracts that encumber Indian lands for a period greater than seven years. Therefore, in conducting business

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Indian Country

Federal law will play a role in any real estate transaction involving a tribal government, inside or outside of Indian lands
within California’s Indian Country, clients should be advised that any real estate transaction should be presumed to require federal approval, unless there is a clear exception. This additional level of approval is sometimes seen as a barrier to commercial activity within Indian Country, but if it is properly managed, it becomes just one additional item necessary to conclude a transaction.

If the transaction with an Indian tribe involves fee lands that are not Indian Country, such as a hotel or business in a metropolitan area, then the transaction will not require federal review or approval because it does not encumber Indian lands. Indian tribes can, and do, own businesses such as franchise hotels, restaurants, and car dealerships on off-reservation lands as an effort to diversify economic opportunities. However, tribal sovereign immunity will need to be addressed in the transactional documents, particularly in light of federal common law that upholds tribal sovereign immunity from suit even for off-reservation activities, absent a waiver of immunity that is “clear and unequivocal.”

Although the topic of federal Indian law can take a treatise to explain, understanding some basic legal terms will enable an attorney to know where to begin in advising a client undertaking a real estate transaction in Indian Country. A grasp of certain legal concepts is key.

“Indian law” is a term used to refer to the body of federal law contained in the U.S. Constitution, treaties, statutes, executive orders, administrative law, and court rulings that apply to Indian tribes and Indians that have retained and continue to exercise powers of self-government in Indian Country.

“Indian tribes” are recognized as governments that obtain their authority from “inherent powers” derived from their original, historical status as entities exercising control over their territory and their members. In many ways, the recognition of tribal governments resembles the manner in which the federal government establishes diplomatic relations with foreign governments. The federal government, acting through the Interior Department’s Bureau of Indian Affairs (BIA), has a formal process for acknowledging the governments of Indian tribes. The BIA publishes a list of recognized governments of Indian tribes in the Federal Register. The term “Indian tribe” does not have one statutory definition for all purposes.

The term “Indian” refers to those individuals who are members of distinct political entities, not individuals of a particular ethnicity or race. Although it is common for each Indian tribe to limit membership based on ancestral lineage, there is normally no strict racial or ethnic requirement. In legal terms, an “Indian” is a person meeting two qualifications: 1) Some of the individual’s ancestors lived in what is now the United States before European contact, and 2) the individual is recognized as an Indian by his or her tribe or community. Generally, tribal membership determinations are left to the exclusive jurisdiction of Indian tribal governments.

The third basic term of Indian law, “Indian Country,” is important because it describes the extent of tribal government territorial and property rights. While the term “reservation” is familiar to the general public, the term “Indian Country” is more expansive and includes other types of property. For example, “Indian allotments” are lands owned by individual Indians and either held in trust by the United States or subject to a statutory restriction on alienation. This form of holding title developed during the federal government’s Assimilation Policy that subdivided or “allotted” communal tribal land holdings to individual tribal members.

Tribal property is unique because it is held in a collective or communal form of title. This status of holding title is not the same as tenancy in common or other common law-based methods of holding legal title. The way that an Indian tribe chooses to use its communal property is subject to the laws of the tribal government, and in some cases, of the federal government. Individual members of the Indian tribe may control these tribal government decisions by participating through the governmental processes of the tribe.

It is well established that the beneficiary of title to tribal land is the tribe itself, not tribal members individually. Even with respect to land allotments, an individual member cannot convey title to tribal land, and with the exception of allotted lands, individual tribal members have no right to a specific part or parcel of tribal property, absent a tribal or federal law or by treaty. However, tribal members often have rights to use tribal property. Rights to use tribal property are determined by the tribe pursuant to its internal political processes, including enforcement of pertinent tribal laws, ordinances, and customs in tribal courts or other tribal forums. One common form of use is through a tribal assignment ordinance, which delineates a system whereby eligible tribal members can establish a life estate in tribal land, subject to compliance with applicable tribal laws.

**Historical Treatment**

The foundations of Indian law in California have their roots in a turbulent past—more than a century of neglect, dependency, and broken promises. California was established by the United States within a territory that was once claimed by a European state but was actually occupied by Indian tribes. As the successor to Mexico, the United States and California inherited the Spanish and Mexican laws governing citizenship and property. In the Treaty of Guadalupe Hidalgo of July 4, 1848, the U.S. government pledged to protect rights to property and to the religious and civil freedoms of Mexican citizens who elected to remain in the United States. Those citizens included California Indians.

Notwithstanding these solemn promises of the federal government, the majority of the California constitutional convention in 1849 voted to deprive California Indians of the civil rights that were promised in the Treaty of Guadalupe Hidalgo. The constitutional convention voted to restrict future voting to white settlers and requested that Indians be removed from the state. In 1850 the California legislature enacted laws that prevented Indians (and others) from giving evidence in any case in which a white person was a party, and authorized the indenture of Indians as uncompensated laborers to white persons. Indians were prohibited from possessing firearms and could not own real property.

During the same period, Congress admitted California into the Union and authorized the president to negotiate treaties with California Indian tribes to cede and relinquish to the United States their title and interest to all lands in California. Treaty commissioners were appointed to negotiate the treaties, and 18 treaties were signed by representatives of 139 different Indian groups or bands between March 19, 1850, and January 7, 1852. Under the treaties, 18 reservations were identified for the use and occupancy of Indian tribes. In exchange for ceding their original land holdings, the treaties promised that the United States would provide clothing and food as well as education in the “art of civilization.” The area to be reserved for the Indian tribes amounted to 8,619,000 acres.

But the California legislature adopted a resolution opposing ratification of the treaties, and in 1852 the U.S. Senate rejected them. Gold had been discovered in California, and those settlers who wielded political power objected to giving Indians such large tracts of potentially valuable land. Without the formal protection of tribal lands by the federal government, the Indian population in California was reduced from nearly 100,000 to only 30,000 during the two decades between 1850 and 1870.

In the absence of reservations established by treaty, a patchwork of military reservations was established by Executive Order of the president. In 1853 and 1855, Congress authorized the creation of seven military reservations, which would provide shelter to surrounding Indians and a means for establishing their own support. In later
decades two publications had an impact on public policy: A Century of Dishonor (1881) details the failures of the United States to protect and assist California Indian tribes, and the novel Ramona (1884) addresses the plight of California Indians. These spurred a renewed effort to reform the federal government's Indian policy. As a result, the Mission Indian Reservations were established in Southern California by Executive Order.

In the early 1900s, Congress passed a series of appropriations acts to acquire land, or “rancherias,” for California Indians. The title to the rancherias is owned by the United States for a particular tribe’s benefit, and the lands are considered Indian Country for all purposes.

Today, California Indian tribes control a limited land base. The Senate’s failure to ratify the treaties with California Indian tribes, and the federal government’s subsequent failure to acquire sufficient lands for the tribes, resulted in a loss of most tribal lands. Currently, 52 tribes have fewer than 200 acres of trust land, and 12 of the 104 federally recognized tribes in California have no trust land at all. This is ironic considering the fact that California Indians once controlled the entire land base of what is now the state of California.

The small size and isolation of most reservations and rancherias has also left California Indian tribes with no control over most traditional tribal cultural sites. California’s many non-federally recognized tribes also suffer because their sovereignty is not acknowledged by the federal government and they have no trust lands. However, all tribes in California have a unique historical tie to their aboriginal lands and cultural resources, regardless of their status.

In 1988, with the passage of the Indian Gaming Regulatory Act (IGRA), Congress formally recognized the inherent right of Indians to conduct gaming operations. IGRA requires tribes to negotiate with states concerning the types of games to be played. It also ensures that tribal governments are the sole owners and primary beneficiaries of gaming. In California, 65 tribes have entered into tribal-state gaming compacts, and 54 of those tribes currently operate a tribal casino.

Tribal government gaming has brought a great deal of attention to California tribes, including opposition to tribal efforts to take additional lands into trust. This is unfortunate for California tribes because the need for tribal land is great. Most tribal governments do not have enough trust land to provide housing and tribal services to all their members. California tribes face great obstacles to placing even contiguous lands into trust. The process for taking lands into trust, despite its complexity and cost, is a challenge tribes must face if they seek to assert tribal jurisdiction over enough land to provide for their members.

Federal statutes and regulations have established mechanisms that authorize the negotiation and approval of leases for business, agricultural, timber, and oil and gas development for both tribal land and individual allotted lands. Federal statutes and regulations also have created a means for Indian tribes to acquire additional lands through “fee to trust” applications, which result in newly acquired lands (that is, “fee” lands) being placed under the control of tribal governments as “trust” lands owned by the federal government for the benefit of an Indian tribe. Conversely, individual Indians may seek to end the restrictions placed on individual allotments through a “trust to fee” application to the secretary of the interior.

Tribal Sovereign Immunity

Lawsuits against Indian tribes—and against subordinate business entities of tribal governments—are barred by sovereign immunity, unless there has been a clearly expressed waiver by the tribe or congressional abrogation. The U.S. Supreme Court recently held that sovereign immunity exists even if the Indian tribe conducts business on lands outside of Indian Country. Therefore, in any business deal involving an Indian tribal government, tribal immunity must be addressed in the transactional documents. A frequent mechanism for addressing prospective dispute resolution is to provide for forum selection, such as a waiver of immunity to suits before a tribal court, or to provide for alternative dispute resolution. To facilitate business, Indian tribes will generally provide a limited waiver of immunity for dispute resolution—but without opening the tribal treasury to unlimited liability.

For example, arbitration provisions can be an efficient way to resolve disputes within the framework of sovereign immunity. The Supreme Court has held that an Indian tribe may waive its sovereign immunity by including an arbitration clause that specifies the American Arbitration Association Rules, under which “the arbitration award
may be entered in any federal or state court having jurisdiction thereof. The Court held that this language was sufficiently “clear” to qualify as a waiver of sovereign immunity.

In establishing an enforceable dispute resolution mechanism, the transactional documents also must correctly select the forum that will have jurisdiction to adjudicate or enforce an arbitration award. As a general rule, state courts do not have jurisdiction to adjudicate disputes that occur within Indian Country. Likewise, federal court jurisdiction is limited, resting on either diversity jurisdiction or federal question jurisdiction. Clearly, parties cannot create federal question jurisdiction by contractual agreement.

Furthermore, the Supreme Court has established a federal abstention rule that favors deference to tribal courts. A tribal court’s determination that it has jurisdiction to adjudicate a dispute may preclude relitigation of the jurisdictional issue in federal court. The par

jurisdiction by contractual agreement. The par

determination that it has jurisdiction to adjudicate a dispute may pre

clude relitigation of the jurisdictional issue in federal court. The par

ties should draft provisions to address the potential subject matter jurisd

tion of tribal forums by expressly opting into or out of these forums. In some cases, the parties may consider opting into a tribal forum, since such an election would be favorably viewed by the tribal government and may reduce the costs and delays associated with litigation in federal or state court.

Federal Approval

Early in the negotiations, the parties must determine whether they need federal approval of the transaction. If so, planning ahead is crucial to address the expectations of the parties regarding the time necessary to conclude and finalize the agreement. Federal approvals generally are not required for fee lands owned by a tribe outside of the tribe’s reservation, because such lands would not be considered Indian Country unless the lands were taken into trust through the fee-to-trust process. Federal approval should be viewed as just an additional step in the closing checklist.

The secretary of the interior must approve any contract or agreement that “encumbers Indian lands for a period of 7 or more years,” unless the secretary, under 25 USC Section 81, determines that approval is not required. The secretary will not issue a “Section 81” approval if the contract in question does not set forth the parties’ remedies in the event of a breach, disclose that the tribe can assert sovereign immunity as a defense in any action brought against it, or include an express waiver of tribal immunity. If the transaction encumbers Indian Country, counsel should assume that the secretary of the interior must approve the underlying contract or lease, unless a clear exception applies. (The secretary delegates responsibility for this process to the assistant secretary for Indian affairs, who is also the head of the BIA.)

Failure to secure a necessary secretarial approval will render the agreement null and void. Several courts have invalidated partially executed agreements involving Indian Country for failure to seek and obtain approval of the secretary of the interior—usually to the consternation of the non-Indian party, who may be lawfully prevented from realizing the benefit of the bargain. Obviously, to avoid the draconian consequences of drafting an invalid agreement, parties should be advised to assume that secretarial approval will be required unless it is clear that the subject matter of the agreement does not encumber Indian Country. The regulations define the term “encum

ber” to mean “to attach a claim, lien, charge, right of entry or liability to real property (referred to generally as encumbrances).” Encumbrances covered by the regulation “may include leasehold mortgages, easements, and other contracts or agreements that by their terms could give to a third party exclusive or nearly exclusive proprietary control over tribal land.” Furthermore, when drafting an agreement for secretarial approval, all of the requirements set out in the regulations must be expressly addressed in the transactional documents.

In order for a tribe to expand its tribal trust land base with the acquisition of new land, it must prepare a fee-to-trust application for review by the secretary of the interior. (The secretary also delegates responsibility for this procedure to the assistant secretary for Indian affairs.) Upon receipt of a complete application, a “Notice of the Application” is published by the Bureau of Indian Affairs, and requests for comments are solicited from all known interested parties, which include the appropriate county board of supervisors and all local governmental agencies, the State Clearinghouse, and the California state deputy attorney general. The tribe has an opportunity to respond to any comments before a final decision is made by the secretary on whether to approve the application.

The standards that must be met for the secretary’s approval are codified in 25 Code of Federal Regulations Part 151. These regulations apply to both Indian tribes and individual Indians, and they govern trust acquisitions whether on the reservation or off the reservation. The regulations state that land may be taken into trust if “the acquisition of the land is necessary to facilitate tribal self-determination, economic development, or Indian housing.” Acquisitions on or adjacent to an existing Indian reservation are treated differently from acquisitions that are located off an existing Indian reservation.

If the land is located within or adjacent to an existing reservation, the applicant must notify local governments having regulatory jurisdiction over the land. The comment period for known interested parties lasts for 30 days. An additional comment period is extended to other interested parties.

In reviewing a fee-to-trust application, the secretary must consider a number of factors, including a mandatory environmental assessment in compliance with the National Environmental Policy Act (NEPA). The most significant factors are whether there will be “[an] impact on the State and its political subdivisions resulting from the removal of the land from the tax rolls” and whether there are any “jurisdictional problems and potential conflicts of land which may arise.” To comply with NEPA, the applicant must either show that there will be no significant impact on the environment or else conduct a comprehensive environmental impact report analysis.

If the land is located outside of and not adjacent to an existing reservation, an applicant must comply with the additional requirements of 25 Code of Federal Regulations Section 151.11. Close proximity of the proposed new land to existing reservation lands is highly favored by the secretary. The regulations specifically state that “as the distance between the tribe’s reservation and the land to be acquired increases, the [secretary] shall give greater scrutiny to the tribe’s justification of anticipated benefits from the acquisition.” In order for the secretary to assess the anticipated economic benefits, the applicant tribe is directed to submit a business plan for the identified off-reservation land the tribe seeks to acquire.

Secretarial decisions to approve fee-to-trust acquisitions have been the subject of various challenges. Any person, Indian tribe, corporation, or other organization whose interests may be adversely affected by a BIA decision may file an appeal of the final agency decision. If a notice of appeal is filed within 30 days of the notice of final decision to take land into trust, the appeal will be accepted by the BIA. A decision on the appeal must be rendered within 60 days after all time for pleadings has expired. Generally, extensions for filing the relevant pleadings are granted. Thus, an appeal can take anywhere from 120 to 180 days to be concluded.

If the BIA finds that an issue in an appeal requires the exercise of discretion, it may refer the issue to the assistant secretary for further consideration or dismiss the issue from the appeal. Otherwise, the final decision for the Department of the Interior is the decision by the BIA. If the appellant is not satisfied with the decision, an appeal may be taken to federal district court for de novo review.

In 1948, Congress authorized the secretary of the interior to
remove the restraints on alienation that were placed on individual allotted lands and approve conveyances if the Indian owner successfully completed an application. Such applications, if approved, will remove all federal restrictions against the sale or leasing of the lands. Because the removal of Indian land from restricted or trust status is controversial, given the historic loss of Indian lands, the interior secretary may withhold approval of the application if he or she “determines that such removal would adversely affect the best interest of other Indians.” Moreover, the secretary may not act on the application until the other Indians or tribes so affected have had a reasonable opportunity to acquire the land from the applicant. Congress authorized the secretary to approve an application and issue a “fee patent” if the secretary determines that the applicant is “competent.”

When an Indian allottee receives a fee patent to a trust allotment, or the federal restriction against alienation is removed from a “restricted fee” allotment, the allottee owns the land in fee simple absolute and can alienate it in any way permitted under the local laws. The restriction on the fee also can be lifted when the stated trust or restriction on the fee expires, or when a non-Indian inherits an allotment, or pursuant to statutes that authorize the secretary to remove the restrictions on alienation on that allotment.

Consulting Agreements, Mortgages, and Security

Section 81 formerly authorized the courts to void an agreement if the court found that it was “relative to” Indian lands. However, Section 81 only applies to arrangements that grant exclusive rights in Indian land. For example, a court refused to apply Section 81 to a consulting agreement to operate a latex glove facility located on the Sioux Reservation in Fort Totten, North Dakota, when the facility would be located at an existing facility owned by the tribe, and the consultant was not given exclusive control of the facility.

Some contracts that are not viewed as encumbering Indian lands may still be subject to other federal approval requirements. For example, contracts to manage gaming facilities are subject to the approval of the National Indian Gaming Commission pursuant to the Indian Gaming Regulatory Act and the regulations adopted by the commission. Consulting agreements may be concluded with a tribal government without the need for federal approval. The factor that distinguishes a consulting agreement from a management agreement is the level of control given to the nontribal party, including that party’s physical presence at the tribal business. To the extent that a consultant is present at
the business on a continuous basis, the BIA will require an increased amount of scrutiny of the arrangement between the parties. Indian lands may not be directly encumbered or made the subject of a foreclosure. However, leasehold interests may be created on Indian land, and given the extremely long term that is authorized in such leases (25 to 99 years), the leasehold can be encumbered subject to the approval of the secretary of the interior. An allotment may also be mortgaged by its Indian owners with the consent of the secretary. Mortgaged land is subject to foreclosure under state law and the terms of the mortgage. The allottees are deemed vested with an unrestricted fee simple title for purposes of foreclosure, and the United States is not a necessary party. However, a state court ruled it lacked jurisdiction over foreclosure actions when the mortgaged land lies within Indian Country.

Security interests also may be created in other assets that do not include the Indian land. For example, a lender may take a security interest in any furniture, fixtures, and equipment on the Indian land and the revenue generated from the economic activity developed on that land without running afoul of the prohibition against encumbering Indian land. In such cases, a lender should perfect the security interest by filing a financial statement under state law and tribal law. Many Indian tribes have adopted commercial codes for this purpose as a means of providing security to those who invest within Indian Country.

Tribal governments as well as individual Indians who own allotted land may exercise their rights in deciding which business ventures they wish to locate on their lands. Parties to real estate agreements need to address the issues of sovereign immunity, subject matter jurisdiction, and secretarial approval in their transactional documents.

2 Worcester v. Georgia, 31 U.S. (6 Pet.) 519 (1832) (ruling that the state of Georgia was preempted by federal authority from regulating the activities within the lands of the Cherokee Nation). The Worcester Court established that the federal government had sole and exclusive political authority to determine the course of dealings with Indian tribes.
to you and your client

However, two of those tribes still have not built a casino. In 2004, seven tribes agreed to amendments to their 1999 compacts. Those tribes currently operate a casino. In 2004, three more tribes entered into compacts, but only two are currently effective because one tribe did not submit its compact to the secretary of the interior for approval. Both of the tribes may operate one gaming facility on the site identified in their individual compacts on Indian lands but have not yet built a casino. In 2003, three tribes entered into compacts, but eight of these tribes are not presently operating a casino. In 2000, Public Law 280, California was devolving Indian Gaming Regulatory Act of 2000, Pub. L. No. 106-179, 114 Stat. 46, codified at 25 U.S.C. §81.

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Also, in a developing trend, state and local governments are testing their ability to exert more and more control and influence over the economic activity that takes place on Indian lands. This includes attempts to tax non-Indian entities that do business in California’s Indian Country.


19 See COHEN, supra note 6, at 530, for a discussion of surface leases. The BIA has promulgated regulations governing surface leases with Indian tribes and individual Indians. 25 C.F.R. pt. 162, 66 F.R. 7109; see 25 C.F.R. § 162.604.

See also American Indian Agricultural Resources Management Act of 1993, which reaffirmed the secretary of the interior’s authority to approve agricultural leases with terms of 10 or 25 years. New regulations that govern agricultural leases were promulgated in 2001. 25 C.F.R. pt. 162.

20 See Vetter, supra note 18, at 177 (discussing the factors that favor a finding that an organization is a subordinate part of tribal government).


25 LaPlante, 480 U.S. at 19.

26 See, e.g., A. K. Mgmt. Co. v. San Manuel Band of Mission Indians, 789 F. 2d 785 (9th Cir. 1986) (holding §81 applicable to a contract for bingo management on the reservation); TTEA v. Ysleta Del Sur Pueblo, 181 F. 3d 676 (3rd Cir. 1999) (assuming §81 applicable to a contract for management of a smoke shop on the reservation); Wisconsin Winnebago Bus. Comm. v. Koberstein, 762 F. 2d 613 (7th Cir. 1985) (holding §81 applicable to a contract for bingo management on the reservation despite an opinion by the Department of the Interior’s Office of the Field Solicitor that the contract did not fall within the scope of §81).

27 25 C.F.R. §84.002.

28 25 C.F.R. §151.3.

29 25 C.F.R. §151.11(b).

30 South Dakota v. United States Dep’t of Interior, 69 F. 3d 878 (8th Cir. 1995), judgment vacated by Department of Interior v. South Dakota, 519 U.S. 919 (1996) (Eighth Circuit held that §5 of the Indian Reorganization Act was an unconstitutional delegation to an administrative agency because there were no articulated standards.).


32 25 C.F.R. §151.2.

33 25 C.F.R. §152.2.


36 See COHEN, supra note 6, at 622 (citing 25 U.S.C. §5483a; 25 C.F.R. §121.34).

37 Id. at 621 (citing Crow Tribe v. Deer Norse, 158 Mont. 25, 487 P. 2d 1133 (1971)).
A guarantor, it can be said, is a fool with a pen. With the abolition in California of the distinction between surety and guarantor, this remark is applicable to anyone “who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor.”¹

The fool armed with a pen is not just someone who has signed a document called a guaranty but also someone who has pledged or mortgaged an asset for another’s debt, as well as someone whose obligation has been assumed by a third party but who remains “on the hook” for that obligation. The suretyship relationship often exists unnoticed except by the experienced observer.

The courts of equity in England and the United States showed a great deal of concern for the plight of guarantors and sureties, exonerating them from their obligations whenever the principal obligor and obligee saw fit to change the contract the guarantor had guaranteed without the guarantor’s consent. It is likely that this solicitude grew not so much out of the guarantor’s status as a fool, for not all guarantors are genuine fools, but out of the courts’ efforts to divine what exactly the guarantor agreed to “answer for.”

If the guarantor guaranteed a note payable on May 1, did the guarantor also agree to guaranty that same note if the payor and payee extended the maturity date to June 1? The negative answer given by the courts of equity² was codified in the California Civil Code along with a litany of other protections accorded sureties and guarantors by the courts of equity—protections that for the most part remain part of the uncodified legacy of the courts of equity in other states.³

Although solicitous of the plight of guarantors, the courts permitted guarantors to be as foolish as they wished so long as they acted with at least a semblance of understanding about the consequences of what they were doing. Guarantors could therefore waive most, if not all, of their judicially created protections. As with the rights themselves, California has codified the surety’s ability to waive its rights.⁴ A guaranty has thus become a document consisting not only of a promise to answer for another’s debt, default, or miscarriage but also page after page of waivers, authorizations, and acknowledgements.

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A guaranty involves at least three par-
ties, even though it is signed by only one of them. A guaranty involves the principal obligor, the obligee, and the guarantor. An obligee has rights against both the principal obligor and the guarantor. Assuming the presence of appropriate waivers on the part of the guarantor, the obligee may collect from either the principal obligor or the guarantor. If the obligee collects from the principal obligor, the guarantor has no further liability under the guaranty and the guarantor has no rights against the principal obligor. If, on the other hand, the obligee collects from the guarantor, the guarantor has rights against the principal obligor.

There are two kinds of guarantor’s rights against the principal obligor. One is direct and the other is derivative. The guarantor has a direct right of reimbursement against the principal obligor for the amounts paid by the guarantor to the obligee on behalf of the principal obligor. The guarantor’s derivative right is known as subrogation, in which the guarantor stands in the shoes of the obligee, as if the guarantor were the purchaser of the obligee’s rights against the principal obligor.

The courts have been wary of any actions that the obligee and principal obligor might take that would adversely affect the guarantor’s reimbursement and subrogation rights without the consent of the guarantor. The classic example of this judicial concern is the well-known landmark case of Union Bank v. Gradsky,4 which involved a guarantor of an obligation secured by California real property. The lender foreclosed on the real property nonjudicially, using its power of sale. Under Code of Civil Procedure Section 580d, following a nonjudicial foreclosure, a creditor may not seek a deficiency judgment against the debtor on the obligation secured by real estate.6 The Gradsky court held that Section 580d barred the guarantor from pursuing the debtor not only as a subrogee of the secured creditor’s claim but also on the guarantor’s reimbursement claim. The court further held that because the creditor had deprived the guarantor of its subrogation and reimbursement rights without the guarantor’s consent, the guarantor should be exonerated from any liability on its guaranty. Gradsky gave birth to the famous Gradsky waiver, which is codified in the Civil Code and designed to alert the guarantor of the risks involved in guarantying a real-estate-secured loan.7

In Western Security Bank v. The Superior Court of Los Angeles County,8 the California Supreme Court addressed whether an issuer of a letter of credit should be barred by Code of Civil Procedure Section 580d from pursuing a foreclosed-out debtor on a reimbursement agreement. In doing so, the court suggested that the Gradsky court might have gone too far in holding that a guarantor may not recover against a principal obligor either on its reimbursement claim or as a subrogee.9 The guarantor necessarily has no claim against the debtor under its right of subrogation following a nonjudicial foreclosure, as the guarantor’s claim against the debtor as a subrogee is no greater than the obligee’s rights—and under Section 580d the obligee’s rights are wiped out. For the Western Security court, the guarantor’s loss of the right of subrogation was sufficient to support the holding in Gradsky. The Gradsky court, therefore, did not have to go the extra step by denying the guarantor any right of reimbursement against the principal obligor following a nonjudicial foreclosure. Whether a guarantor retains or loses its right of reimbursement after a nonjudicial foreclosure may yet be adjudicated, but not in a case in which a guarantor seeks to be exonerated under Gradsky, because the Gradsky waiver is boilerplate in virtually every guaranty in circulation today.

The often misunderstood and sometimes maligned “one action” rule and antideficiency limitations have threatened the efficacy of guaranties on more than one occasion. Indeed, each court ruling in this area has led to a seemingly inevitable legislative response. Gradsky is one example. Another was the unpublished Bank of Southern California v. Dombrow,10 in which the court held that a Code Section 2856 permits the guarantor to waive every right and protection set out in the Civil Code, as well as all rights a guarantor may have under California’s antideficiency and one-action rules under Code of Civil Procedure Sections 580a, 580b, 580d, and 726. Moreover, Section 2856 contains user-friendly safe-harbor language that the courts can construe only one way—in favor of a waiver. Yet despite Section 2856, lawyers remain cautious in rendering third-party legal opinions on the enforceability of waivers in guaranties.12 There is a sense that in an egregious case, the courts will decide to wield their equitable powers to limit even the most expansive waiver—notwithstanding the fact that the waiver is engrained in the statute books.

**SPEs and Nonrecourse Carve-Outs**

If the legislature had not rendered moot some of the issues involved in the protection of guarantors with the passage of Section 2856,
MCLE Test No. 144

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. A guarantor is anyone who promises to answer for the:
   A. Debt of another.
   B. Default of another.
   C. Miscarriage of another.
   D. All of the above.

2. When a guarantor has guaranteed a note payable on a certain date, the guarantor has also in effect agreed to guaranty the same note if the payor and payee choose to extend the maturity date by 30 days.
   True.
   False.

3. What judicially created protections may a guarantor effectively waive under the Civil Code?
   A. None.
   B. A guarantor may only waive “fair market value” protections.
   C. A guarantor may waive antideficiency and one-action protections.
   D. A guarantor may waive all judicially created protections.

4. The Civil Code has codified certain protections for guarantors and sureties.
   True.
   False.

5. In Union Bank v. Gradsky, was the guarantor exonerated from liability on its guaranty?
   A. Yes, because the creditor had foreclosed judicially, so the creditor could not seek any deficiency judgment—and neither could the guarantor.
   B. Yes, because the guarantor had deprived the guarantor of its subrogation and reimbursement rights without the guarantor’s consent, so the court employed an estoppel justification to exonerate the guarantor.
   C. Yes, because the creditor could not foreclose via power of sale, so neither could the guarantor, thereby exonerating the guarantor from any liability whatsoever.
   D. No.

6. In Western Security Bank v. The Superior Court of Los Angeles County, the guarantor’s loss of the right of contribution was sufficient to support the holding of Gradsky.
   True.
   False.

7. The court in Western Security confronted a guarantor obligation secured by membership interests in the single purpose entity (SPE) that was the owner of the real property.
   True.
   False.

8. In Western Security, the guarantor’s loss of the right of subrogation was sufficient to support the holding of Gradsky.
   True.
   False.

9. Considering the scope of Civil Code Section 2856, an attorney is afforded complete protection in rendering a legal opinion regarding the enforceability of waivers in guaranties.
   True.
   False.

10. Under a completion guaranty, if the debtor/builder fails to complete the project, the completion guarantor must complete the construction.
    True.
    False.

11. The completion guaranty constitutes a promise by the completion guarantor to pay a certain loss in value to the security that is the result of noncompletion.
    True.
    False.

12. If the lender is fully secured at the time of foreclosure (and assuming the debtor/builder has failed to complete the project), the lender may recover fully from the completion guarantor.
    True.
    False.

13. A debtor may waive the one-action rule.
    True.
    False.

14. A guarantor may waive the antideficiency rules.
    True.
    False.

15. A debtor may waive the antideficiency rules.
    True.
    False.

16. A guarantor may waive the antideficiency rules.
    True.
    False.

17. What is the term commonly used to refer to a guaranty that, in substance, is structured to 1) afford a guarantor certain debtor protections, such as the one-action rule and the antideficiency rules, and 2) places the guarantor in the same economic position as that of the debtor?
   A. Sham guaranty.
   B. Contribution guaranty.
   C. True guaranty
   D. None of the above.

18. Under Code of Civil Procedure Section 580d, a creditor, following a nonjudicial foreclosure, may seek a deficiency judgment against the debtor on the real estate-secured obligation.
    True.
    False.

19. Under Section 580d, following a judicial foreclosure, a creditor may seek a deficiency judgment against the debtor on the real estate-secured obligation.
    True.
    False.

20. The court in Western Security addressed whether Section 580d should bar an issuer of a letter of credit from pursuing a foreclosed-out debtor on a reimbursement agreement.
    True.
    False.

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15. □ True □ False
16. □ True □ False
17. □ A □ B □ C □ D
18. □ True □ False
19. □ True □ False
20. □ True □ False
commercial practice would nevertheless have made those issues less meaningful, at least in the arena of commercial real estate loans. A large proportion of real estate loans today are made to single purpose entities (SPEs), whose sole asset is the real estate encumbered by the lender’s first deed of trust. With only a single real estate asset, and therefore limited business activities and a limited number of unsecured creditors, the borrower who is an SPE is less likely to go bankrupt—and even if it does go bankrupt, the lender is more likely to obtain relief from the automatic stay and to be able to foreclose. A guarantor of an SPE’s real estate secured debt is taking on the risk that the guarantor in Gradsky perhaps never understood. The guarantor of an SPE’s debt knows that after the lender forecloses on its security, there is going to be nothing left in the SPE from which the lender could obtain reimbursement—and there is nothing that the lender could have obtained beyond the foreclosed upon property even if the lender had foreclosed judicially. As a practical matter, the use of an SPE makes Gradsky meaningless.

The advent of the SPE has also seen the increased use of the nonrecourse loan, with its so-called nonrecourse carve-outs. A lender has little use for a personal judgment against a debtor whose sole asset is encumbered by a first trust deed in favor of the lender. It is nonetheless commonplace for lenders to carve out certain liabilities on the part of the debtor from the lender’s agreement not to seek a personal judgment against the debtor. These nonrecourse carve-outs are gradually becoming standardized in loan documentation, to such an extent that lawyers often resort to arguments about whether a particular carve-out is “market.”

The bulk of the nonrecourse carve-outs are for those acts or omissions that fall under the “bad boy” rubric. These include waste, fraud, and other intentional acts of misconduct injurious to the lender. For California lawyers, one way to approach most nonrecourse carve-outs is to ask whether a debtor would be liable to the lender for the act or omission if the deed of trust had been foreclosed nonjudicially. If a debtor is liable to a lender for an act or omission following a nonjudicial foreclosure, the lender is going to challenge the debtor’s arguments, although under some nonrecourse carve-outs, the loan may become full recourse for certain egregious acts by the debtor. When the lender’s recovery is limited to the amount of loss suffered by the lender, an issue generally left unaddressed is how to measure this loss.

After the Dombrow court addressed whether the guarantor should receive credit for the fair market value of the foreclosed real property in determining the extent of the guarantor’s liability for a deficiency, the legislature provided, under Section 2856, that a guarantor could waive the right to such a credit. All guaranties contain these waivers, even nonrecourse carve-out guaranties. The question that remains is whether the waiver adequately addresses what the guarantor and lender meant by losses or injuries suffered by the lender arising out of the bad boy acts or omissions of the borrower. The guarantor has a strong argument that the lender suffered injury or harm only to the extent the debt and any losses suffered by the lender from the bad boy acts or omissions exceeded the fair market value of the foreclosed real estate—not the amount bid by the lender for the foreclosed real estate. If the lender desires a different result, the lender will need more than a Section 2856 waiver to achieve it.

The measure of a guarantor’s liability is an issue that applies not only to limited guaranties but also to completion guaranties, which are given to guaranty the completion of projects that are being funded by construction loans. The issue is similar to that posed by the nonrecourse carve-out guaranty. How does one measure the injury to the
lender by the borrower’s failure to complete the building? The guarantor under the completion guaranty does not actually declare that if the borrower fails to complete the building, the lender can force the guarantor to complete it. The completion guaranty often contains language stating that if neither the guarantor nor the borrower completes the building, the lender may complete it and charge the guarantor for the cost of completion. Perhaps fearing a staggering bill for completion of the project, guarantors and their counsel often try to negotiate elaborate provisions permitting the guarantor to step into the shoes of the borrower and complete construction with the use of the lender’s loan funds. These negotiations are likely to be pointless should the borrower fail to complete the construction, because the completion guarantor is generally a principal of the borrower and the only source besides the lender of funds for the borrower. If the borrower cannot complete the building, the completion guarantor is not likely to be able to either.

Moreover, the completion guarantor’s fear may be baseless. Under Glendale Federal Savings & Loan v. Marina View Heights Development Company, the lender may not be able to recover for sums expended by the lender in finishing the building the borrower and completion guarantor failed to complete. The completion guaranty is merely a promise by the completion guarantor to pay the loss in value to the security resulting from the failure to complete. Indeed, if the lender is fully secured on the date of foreclosure, there is no recovery under the completion guaranty. The court in Marina View Heights did not specifically address how to determine whether a guarantor is fully secured, but generally the fair market value of the foreclosed property is used, not the foreclosure sale price.

The completion guaranty also is not a guaranty of the deficiency arising by virtue of the difference between the amount of the debt and the value of the collateral. This deficiency may be attributable to a downturn in the economy or a decline in the value of comparable properties. A deficiency that is a result of these market factors would not be covered by a completion guaranty. The completion guaranty is a guaranty that the lender will receive the promised performance, which is the value of the real property security with the completed building. The loss to the lender is measured by the value of the real property collateral as if it had been completed, less the value of the real property in its unfinished state and the cost to complete.

Borrowers use SPEs generally because lenders want them to, although there is a benefit to a borrower in spreading assets among various entities to prevent one trou-
bled property from infecting an entire real estate enterprise. Loan applications often state that the real property is to be owned by an SPE and that a person or entity with an interest in the SPE is to guaranty the loan. In a line of cases, California courts were confronted with guarantors who argued that their guarantees were sham guarantees because the lender had required the guarantor to place the property into an entity and then guaranty the entity’s debt. By requiring the guarantor to form an entity and guaranty the entity’s debt, the lender had in effect obtained a waiver of the one-action and antideficiency rules that otherwise would have protected the guarantor, who in those cases would have remained as the debtor. If the guarantor was successful in its argument, the guarantor would have no liability on its guaranty, as the one-action and antideficiency rules are not waivable by the debtor.

In these sham guaranty cases, the guarantors were using a variant of the alter ego theory to shield themselves from liability. The question that may confront courts if the real estate market slows down and SPE structures are tested for the first time is whether the lender’s requirements that the property be held by an SPE and guaranteed by an owner of the SPE are comparable to compelling the true borrower—that is, the guarantor—to waive the benefits of the one-action and antideficiency rules. Unlike lenders in the earlier cases addressing sham guaranties, the lenders who require the deep-pocket-entity borrower to set up an SPE are doing so for reasons other than the right to go after the deep pocket entity as a guarantor for a deficiency. Moreover, the guaranty itself in most cases is for bad boy acts or omissions, which are outside the protections afforded by the one-action and antideficiency rules. Nonrecourse carve-out guaranties made by the parent entities of SPE borrowers are, therefore, unlikely to be struck down as sham guaranties, despite the overt structuring that lenders engage in when they are negotiating the terms of their loans. To suggest that courts should not strike down these guaranties as a sham is not to suggest that lawyers will not make this argument when lenders seek to recover on the guaranties.

Guarantors may be foolish, or just a tad overly optimistic, and perhaps California courts will always hesitate, at least for a moment, before imposing liability on this quondam protected class. It is likely, however, that the simple idea of the guaranty—that a guarantor will do what the principal fails to do—will continue to be expressed in lengthy documents echoing the ancient wisdom of the English Chancery and the more modern struggles of Gradsky and Dombrow.

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Formal Opinion No. 514: Ethical Issues Involving Lawyer and Judicial Participation in Listserv Communications

I. SUMMARY OF OPINION: Listserv communications present the possibility for ex parte communications between lawyers and judicial officers who are involved in a case. Inadvertent contact, in that context, likely violates no ethical proscription; and, too, lawyers may rely upon the independent duties of judges to avoid such ex parte contacts. Regardless, however, problems could still arise depending upon the communication’s nature, or an unintended recipient’s response. Since attorneys must always remain mindful of their duties to protect confidential client information, and one never knows who might read or react to e-mail posted to a listserv, attorneys should avoid including information in listserv postings identifiable to particular cases or controversies.

II. HYPOTHETICAL PREMISE FOR OPINION: A local bar association section is composed of practicing lawyers and members of the bench. In order to facilitate communication among these individuals, the bar has created a listserv. All the members of the section are permitted to participate in a free flowing exchange on the listserv of information, including tips on procedure, research, drafting documents, and litigation techniques. One member posted an inquiry on the listserv seeking an accountant to serve as an expert witness. Another responded by recommending a specific CPA and included the CPA’s credentials. Yet another member read the recommendation and replied with sharp criticism of that same CPA. A judge who actively participates on the listserv read the messages, realized that this particular CPA was scheduled to testify the next week before the judge, and then posted his own message on the listserv advising that messages be censored in order to avoid ex parte contacts.

III. QUESTIONS PRESENTED: Do lawyers participating in e-mail communications with a listserv or “chat room” risk engaging in improper ex parte communications if judges in front of whom the lawyers may appear also have access to that same information? If a judge on the listserv encounters a communication pertinent to a case in which he or she is presiding, do the listserv communications constitute improper ex parte communications with the judge? What are the obligations and duties of a judge who receives a communication pertinent to a pending case? Do listserv communications create special issues regarding lawyer’s duties of confidentiality?


V. DISCUSSION

1. A Listserv Is An E-Mail Rendering of the “Letters to the Editor” Page

The methods that attorneys use to communicate with their clients have changed along with developments in technology. We once mailed letters or faxed information. Now we employ digitalized methods of communicating with clients and others. Regardless of the methods used to communicate with their clients and other lawyers, attorneys must maintain their clients’ confidences and secrets. Few ethics rules anticipate the mode of communication to be used or its potential problems. A communication between attorney and client does not lose confidentiality solely because it is transmitted by fax, cell phone, or other electronic means. Lawyers are not required to encrypt e-mail containing confidential client communications.

The LACBA Professional Responsibility and Ethics Committee (PREC) prepares written opinions and responds to questions by lawyers concerning lawyers’ ethical duties and responsibilities. You may access PREC’s formal opinions through the LACBA’s Web site at www.lacba.org/showpage.cfm?pageid=427. Formal opinions are completed within six months to a year. If you have a legal ethics issue (not currently in litigation), please contact Grace Danziger at (213) 896-6407 or gdanziger@lacba.org.
communications because e-mail poses no greater risk of interception and disclosure than regular mail, phones, or faxes.\(^5\)

So it is no longer uncommon for attorneys and clients to communicate with one another, and with third parties, through e-mail. But some of the very advantages in using e-mail impose risks not inherent in more traditional forms of communication. Because e-mail is relatively informal, it may contain content not appropriate for should-be-formal communications. Because e-mail content is electronic and therefore invisible to the human eye, e-mail can contain hidden content, either data, or malicious programming. E-mail can also be sent simultaneously—inadvertently or intentionally—to thousands of e-mail addresses,\(^7\) yet it is impossible to know who might have read any given e-mail unless a recipient confirms the same. An e-mail “address” is an anonym—it merely identifies an e-mail account; it neither specifies any particular computer nor identifies any of the persons who might receive the e-mail sent to that address.

A listserv is a public conversation. It is transmitted through the World Wide Web, which, as a whole, has been analogized to a public bulletin board.\(^8\) Even communicating through a closed listserv\(^9\) is like e-mailing a message to thousands of e-mail addresses,\(^7\) yet it neither specifies any particular computer nor identifies any of the persons who might receive the e-mail sent to that address.

A listserv is a public conversation. It is transmitted through the World Wide Web, which, as a whole, has been analogized to a public bulletin board.\(^8\) Even communicating through a closed listserv\(^9\) is like e-mailing a letter to the editor of a newspaper, or participating in a call-in radio show or a conference call, via e-mail. Although the hypothetical may seem not to involve client confidences, such concerns must be paramount at all times. New forms of communication can seductively cause lawyers to forget their ongoing duty to maintain the confidence of their respective clients.

Since, for the purposes of this discussion, it is the content of the e-mail which is critical, it ought not matter whether one is seeking or furnishing information through a listerv. An attorney responding to a request for an expert or other information on a listerv is not necessarily rendering legal services\(^10\) within the meaning of the ethical rules; particularly where opinion about another is the only information being conveyed. Nor would the request on a listerv for information such as an expert referral seem to impair obligations of confidentiality.

But given the inherently public nature of a listserv, a discussion about an expert referral on a listserv, whether requesting or responding with information, could impair a lawyer’s ability to continue representing a client, by improvidently disclosing information or engaging in ex parte communications with members of the bench.\(^11\) Arguably, an attorney opining in reply about an expert might reveal mental impressions and effect a waiver of work product doctrine. Though “work product” is a statutory creation affecting evidentiary rather than ethical concepts,\(^12\) and despite that the attorney—not the client—is the exclusive holder of work product protection,\(^13\) a cavalier waiver of work product protection could have adverse impact and might be rued.\(^14\)

2. Lawyers Must Always Avoid “Ex Parte” Communications with Judges Concerning the Merits of Pending Matters

A lawyer “shall not directly or indirectly communicate with or argue to a judge or judicial officer upon the merits of a contested matter pending before such judge or judicial officer, except: (1) In open court; or (2) With the consent of all other counsel in such matter; or (3) In the presence of all other counsel in such matter; or (4) In writing with a copy thereof furnished to such other counsel; or (5) In ex parte matters.”\(^15\)

Ex parte contacts with judges erode public confidence in the fairness of the administration of justice, “the very cement by which the system holds together.”\(^16\) The prohibition and restrictions “apply equally whether the judge or the lawyer initiates the contact.”\(^17\)

Rule 5-300(B) incorporates two critical principles. The communication must be on the merits, and it must involve a pending matter. Yet an attorney can willfully violate an ethical rule without engaging in any evil or bad faith,\(^18\) and without even knowing the specific rule he or she is violating.\(^19\)

Though an “innocent” suggestion of an expert witness in response to an inquiry would seem to lack the specific knowledge required for liability under the rule, even an “innocent” (i.e., negligent) ex parte contact would still violate 5-300(B), since no intent to engage in an improper communication is required.\(^20\)

The contact with the judge suggested in the hypothetical was inadvertent because it was not intended by the attorney. Suggesting an expert, or commenting upon an expert on a listerv, does not evince any intent to engage in direct or indirect contact with the judge.\(^21\) However, in order to reduce the likelihood of any kind of unintended ex parte contact, lawyers using listservs must always consider who else may have access.\(^22\)

3. Judges and Other Judicial Officers Must Be Circumspect about Avoiding Ex Parte Communications with Lawyers and Litigants

The attorney’s contact with the judge in the hypothetical was inadvertent; the judge’s following warning message was not. Judges have their own independent duties to try to avoid situations where unintended and inadvertent communication regarding issues in controversy might be discussed in their presence. A judge should ignore rather than respond to information mistakenly received about a pending matter.\(^23\) Information received by a judge from participating in a listerv is no different.

However, members of the bench do not forewear participating in society when they become judges. The legal community benefits from having judges remain active in bar affairs.\(^24\) Members of the bench are also exposed to legal commentary and details about cases in the media. Judges may accidentally overhear counsel discussing cases in hallways or around the courthouse. Such random inadvertencies are not unusual and do not mandate judicial recusal unless significant details are imparted or actual prejudice inures. Judges have learned to turn a blind eye regardless of how this information is transmitted.

Yet, while judges may speak in and write to public forums, through bar associations or otherwise,\(^25\) they should approach this opportunity with caution. A listerv, as mentioned, is a public forum whether open or closed.\(^26\) Accordingly, any judge communicating on a listerv must remain aware that he or she is communicating (even as a passive reader) with an unknown segment of the public—a public which includes persons who may appear as parties or advocates before that judge.

The risk of engaging in prejudicial ex parte communications through a particular listerv increases in proportion to the listerv’s connection to the legal jurisdiction in which the judge sits. A judge who communicates through a local bar association listerv must be more circumspect than when engaged with a non-legal-themed listerv, or a listerv not focused on subjects within the judge’s jurisdiction. Likewise, a judge who participates in a listerv that includes attorneys who may potentially appear before that judge should expect from time to time to have to delete e-mail without reading it. A judge ought not join a litigation advocacy group, for example, if the exposure to lawyers’ inadvertent communications creates a potential problem.\(^27\) To avoid even the potential for such problems, some attorney or litigation listervs forbid judges outright.

4. Lawyers Acting as Temporary Judges or Arbitrators Must Avoid Ex Parte Communications as Scrupulously as Sitting Judges

Even if no sitting judges are known to be on a listerv, many practicing lawyers and retired judges serve as assigned judges, private judges, judges pro tem, and arbitrators. Such persons must be mindful of the ramifications of ex parte contact from the perspective of a sitting judge. When acting as advocates, lawyers have no duty to avoid information received “ex parte,” but lawyers who act as temporary judges or arbitrators must avoid ex parte communications just like sitting judges.\(^29\)

Like sitting judges, temporary judges and
arbitrators must also avoid appearances of impropriety,30 and must likewise avoid improper ex parte communications concerning pending matters.31 Whereas Rule 1-710 applies relevant portions of the Code of Judicial Ethics to attorneys acting as court-appointed arbitrators, Section 1281.85 of the Code of Civil Procedure imposes Judicial Council ethics standards upon arbitrators who are not court-appointed.12

VI. CONCLUSION

A lawyer who honors every ethical duty still cannot be guaranteed that nothing will go wrong. For instance, lawyers have no ethical duty to encrypt confidential communications although that would minimize the risk that such communications could be read by unintended recipients. Likewise, judges must try to avoid ex parte contact concerning matters which will or may come before them, but there is no surefire way to prevent it from occurring. Since one can never know who might read or react to e-mail posted on the Internet, and because it is likely that judges will be included in listservs or other open communication lists, it is incumbent upon attorneys to avoid including any confidential or private information in a listserv or other Internet posting that could be identified to a particular case or controversy.

This opinion is advisory only. The Committee acts on specific questions and its opinions are based on such facts as are set forth in the inquiry submitted to it.

1 A listserv is a public or semipublic, nonconfidential forum for the exchange of e-mail. Like a newsgroup where people exchange information about a wide array of subjects, listservs use the Internet e-mail system to exchange messages. Each listserv targets predetermined topics and discussions. Subscribing to a listserv group adds the subscriber’s name to its mailing list—every time someone sends an e-mail to the group, that e-mail is automatically forwarded to everybody on the listserv’s mailing list. Listserv software was developed in the mid-1980s, and the term is now used generically to describe electronic mailing lists. Although L-Soft International, Inc., has registered “Listserv” as its trademark, this opinion references no trademark and only uses “listserv” in the generic sense.

2 A chat room is a place on the Internet where people with similar interests can meet and communicate together by typing synchronous messages on their computer. Most chat rooms have a particular theme, but a theme is not required. Often, people can enter a chat room without any verification of who they are. “It is the duty of an attorney…[t]o maintain inviolate the confidence and secrets of his or her client.” BUS. & PROF. CODE §6068(e)(1). “[T]he protection of confidences and secrets is not a rule of mere professional conduct, but instead involves public policies of paramount importance which are reflected in numerous statutes.” In re Jordan, 7 Cal. 3d 930, 940-41 (1972).

3 California Business and Professions Code §§6158 through 6158.3, which govern attorney advertising by “electronic media,” are unusual since most expressions of attorney ethics fail to specify the mode of communication.

4 EVRD. CODE §952; 18 U.S.C.A. §523(b)-(4)—privileged wire/oral transmissions intercepted in accordance with (or in violation of) federal wiretapping statute do not lose their privileged character; Orange County Bar Assn. Form. Opn. 97-002. Correspondingly, the First Circuit held in its en banc decision in United States v. Councilman, 2005 WL 1907528 (1st Cir. Aug. 11, 2005) that a third party’s interception of e-mail while on its way to the recipient violates the Electronic Communications Privacy Act.

5 ABA Form. Opn. 99-413—uncrypted email sent over the Internet “affords a reasonable expectation of privacy from a technological and legal standpoint;” see also Orange County Bar Assn. Form. Opn. 97-002, concluding that encryption is encouraged but not required. 6 Unsolicited commercial e-mail (“UCE”) is almost universally called “spam,” because of a Monty Python skit wherein a group of Vikings sang a chorus of “SPAM, SPAM, SPAM…” in an increasing crescendo, drowning out other conversation. Hormel Foods Corporation (which does not object to use of the term “spam” to describe UCE so long as it is all in lower case) says the “analogy applied because UCE was drowning out normal discourse on the Internet.” See http://www.spam.com/cgi_in.htm.

6 Wilbanks v. Walk, 121 Cal. App. 4th 883, 897 (2004), concluding Web site statements were made in a public forum.

7 A listserv may be open to all, or it may be “closed,” that is, its access may be limited to particular members or registrants. For instance, the Association of Professional Responsibility Lawyers (APRL) maintains a closed listserv for its membership—access is available only to its members.

8 As regards workers’ compensation, the term “legal services” includes “any service which refers potential clients to any attorney.” BUS. & PROF. CODE §5499.30(b).

9 See, e.g., Bell v. Staacke, 159 Cal. 193, 196-97 (1911) (letter to opposing counsel as admission).

10 See CODE CIV. PROC. §2018.


12 See, e.g., Izzagai v. Superior Court (People), 54 Cal. 3d 356, 385 (1991), discussing “how the work product privilege plays an essential role in enabling attorneys to properly represent their clients’ interests” and avoids “[i]nadequacy, unfairness and sharp practices”; and McKesson HBOC, Inc. v. Superior Court (State of Oregon), 115 Cal. App. 4th 1229, 1240 (2004) (Parties’ interests in maintaining confidentiality might be damaged if work product disclosed.).

13 California Rule of Professional Conduct 5-300(B)(5).

14 The Rules of Professional Conduct prohibit only unauthorized ex parte contact and not, e.g., an ex parte application made pursuant to Rule 379 of the California Rules of Court.


17 An attorney’s concerns for his and a co-counsel’s personal safety, when communicated on an ex parte basis to an administrative law judge, violated Rule 5-300 regardless of the perceived justification; see also McKnight v. State Bar, 53 Cal. 3d 1025, 1034 (1991) (violation of Business and Professions Code §6108).

18 Durbin v. State Bar, 23 Cal. 3d 461, 467 (1979) (bad faith not a necessary element of “willfulness” under California Rules of Court, Rule 953); and King v. State Bar, 52 Cal. 3d 307, 313-14 (1990): “We have also held in other contexts that to establish a willful breach of the Rules of Professional Conduct, ‘it must be demonstrated that the person charged acted or

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omitted to act purposely, that is, that he knew what he was doing or not doing and that he intended either to commit the act or to abstain from committing it. (Citations.) Willfulness of an act is thus not necessarily dependent upon knowledge of the provision which is violated. (Citations.)


20 "An attorney’s misconduct need not be in bad faith to be willful; rather, all that is required is a general purpose or willingness to commit the act or permit the omission." (Citation.) Edwards v. State Bar, 52 Cal. 3d 28, 37 (1990).

21 Though Paragraph C of Rule 5-300 expressly refers to ex parte contact with a "judge" or "judicial officer," including "law clerks, research attorneys, or other court personnel who participate in the decisionmaking process," Rule 5-300(C) has been interpreted as also prohibiting ex parte contacts with Administrative Law Judges. See Zaheri v. New Motor Vehicle Board, 55 Cal. App. 4th 1303 (1997), wherein the court traced the history of Rule 5-300 back to the original Rules of Professional Conduct in 1926, and held that Administrative Law Judges are not "within the compass of the term 'judicial officer' as used in the Rules of Professional Conduct." Nevertheless, Zaheri goes on to state: "Nonetheless, the law of legal ethics is not limited to written law; it partakes of a common law or 'unwritten law' (Code Civ. Proc. §1899) aspect. (See, e.g., rule 1-100(A), Rules Prof. Conduct.) There is no principled basis to distinguish between an ALJ and a judge in the judicial branch for purposes of ethical strictures against ex parte contacts. Hence, we find the same standard applicable." 55 Cal. App. 4th at 1317.

22 Caution is needed when using a listserv whether it is open or closed (see note 9). The listserv in the hypothetical could be considered closed because its use is limited to members of the local bar association. Though the attorney in the hypothetical might not have posted the expert witness inquiry on an open listserv, the same issues would arise if he or she did.

23 A judge must expect to be the subject of constant public scrutiny. A judge must therefore accept restrictions on the judge’s conduct that might be viewed as burdensome by other members of the community and should do so freely and willingly. Advisory Comm., foll. Canon 2A, Cal. Code Jud. Ethics.

24 For example, the American Inns of Court “give judges and lawyers an opportunity to discuss the ethical and professional issues that they share” (http://www.linsofcourt.org/contentviewer.asp?breadcrumb=s,9,343,) and the Association of Business Trial Lawyers, “committed to promoting and enhancing communications between the bar and the federal and state benches” (http://www.abtl.org/welcome.htm) claim that 20 to 30 judges attend their dinner seminars. Nothing prohibits a lawyer from chatting with or having a drink with a judge, so long as there is no discussion of a case involving the lawyer over which the judge is presiding. (See the discussion of Rule 5-300, above.)


26 See note 9, above. The listserv in the hypothetical, for instance, which would seem to be limited to use by members of the local bar association, could be considered a “closed listserv.”

27 A judge shall so conduct the judge’s quasi-judicial and extrajudicial activities as to minimize the risk of conflict with judicial obligations.” Canon 4, Cal. Code of Jud. Ethics.

28 Washburn University School of Law’s Legal Ethics list, for example, is “restricted to lawyers, law professors, and law students only...[and]...available only to attorneys, law professors, and law students.” WashLaw Your Guide to Legal Information on the Internet, http://lists.washlaw.edu/mailman/listinfo/legalethics/ (bolding in original).

29 Rule 1-710, permitting discipline of lawyers who violate applicable portions of the Code of Judicial Ethics while acting in a judicial capacity. “A member who is serving as a temporary judge, referee, or court-appointed arbitrator, and is subject under the Code of Judicial Ethics to Canon 4D, shall comply with the terms of that canon.” The Official Discussion states that Rule 1-710 is intended to regulate attorneys “while acting in a judicial capacity.”

30 “An arbitrator must act in a manner that upholds the integrity and fairness of the arbitration process. He or she must maintain impartiality toward all participants in the arbitration at all times.” Cal. Rules Ct., Appendix, Div. VI, Ethics Standards for Neutral Arbitrators in Contractual Arbitration, Section 5. “An arbitrator [must avoid creating an appearance of impropriety but] does not become partial, biased, or prejudiced simply by having acquired knowledge of the parties, the issues or arguments, or the applicable law.” Cal. Rules Ct., Appendix, Div. VI, supra, Advisory Committee Comment to Section 5.

31 “An arbitrator must not initiate, permit, or consider any ex parte communications or consider other communications made to the arbitrator outside the presence of all of the parties concerning a pending or impending arbitration, except as permitted by this standard, by agreement of the parties, or by applicable law.” Cal. Rules Ct., Appendix, Div. VI, Ethics Standards for Neutral Arbitrators in Contractual Arbitration, Section 14(a).

32 California Code of Civil Procedure §1281.85 provides in part, “a person serving as a neutral arbitrator pursuant to an arbitration agreement shall comply with the ethics standards for judges adopted by the Judicial Council pursuant to this section.”
Regrettably, the third bar—the execution of the book—falls short. As a result, the publishing jackpot may remain, for the moment at least, just out of reach. Green Weenies is self-published—by what is known in the trade as a “vanity press,” a phrase that (perhaps not coincidentally) does not appear in the book. While this take-charge, do-it-yourself attitude may be a laudable pillar of American business, there is something to be said for the refinement and polish that come from professional editing and publishing. The foundation of the book is good, and its problems can be corrected if there are subsequent editions, as Sturgeon plans. Until then, the disappointments—the missing pieces that keep it short of becoming a Scott Adams-like humor classic or a Wall Street Journal must-have resource—have all the hallmarks of a lack of sophisticated and unbiased review and editing process.

Chief among the disappointments is a nagging concern whether the book really provides readers with their money’s worth. It is true that many of the words and phrases are truly entertaining business world expressions that one can hope to use in some future meeting. For example, to “fuzzify” means to make something less clear, “chipmunking” means thumbing a handheld communications device, an “idea hamster” is someone who constantly generates ideas but does not follow through, and “weatherman syndrome” means making predictions while isolated from the real or practical world. These are interesting words or phrases that make sense when defined and that might not otherwise be intuitively obvious. Even if the reader gleans nothing else, there is something to be said for the sheer entertainment value of being able to say, “Well, they tried hard with their investment analyst presentation, but there isn’t enough eye candy (graphics used to make the message look better), eye test (fine-print data) or wiggling hips (spin to make something look better) in the world to put lipstick on that pig (make something ugly look better).”

However, too many of the book’s words and phrases are just part of today’s common jargon and are not mysterious or difficult to comprehend. Maybe not everyone has heard the expression “the toothpaste is out of the tube” (it is too late to take something back), but the expression has many parallels (“the horse is out of the barn” or “no use crying over spilled milk,” for example), and in any event it is not too hard to figure out what the phrase means. Similarly, “scorched earth,” “peanut gallery,” “gravy,” and an idea that “won’t hold water” will not be new terms to most of the people who toil in business or professional fields.

Green Weenies is separated into two parts: the unusual or humorous words and phrases—the “green weenies”—and more traditional, serious words and phrases—such as “due diligence”—that people in business and related professions have adopted. These two parts are broken down further into areas of business, such as management, sales, accounting, human resources, mergers and acquisitions, and legal.

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Unfortunately, it is hard to avoid feeling that the due diligence part of the book was added only to increase page count and with the hope of gaining credibility as a serious business reference. The serious section is shorter than the green weenies section, even though the number of potentially serious words and phrases is enormous, and the overall quality and detail of the definitions in the due diligence section reflect Sturgeon’s lack of inspiration regarding the entire business lexicon. The simple definitions may be enough for the neophyte, but they are less helpful for those who may need more. Sturgeon writes: “These [due diligence] chapters just aren’t as much fun….I have tried to include only those that I recall using or those that are most important.”

*Green Weenies* is illustrated, which is a nice idea for a book of this genre. The illustrator is the well-known and much-published cartoonist and author Gahan Wilson, whose work has been featured regularly in *The New Yorker*, *Playboy*, and numerous collections. Wilson’s odd and occasionally gruesome humor is often well suited to the equally odd and occasionally gruesome wit and wisdom of the boardroom—for example, “blood on the floor” (a severe consequence for a poor performance). It is too bad that often in this book, Wilson’s illustrations are nothing more than literal pictures of figurative speech, neither advancing an understanding of the speech nor providing a meaningful diversion from the text. As a result, Wilson’s contribution to the book is disappointing for its failure to fulfill its potential.

It is rare that a self-published title receives much attention. *Green Weenies* may become one of the exceptions. The book is already carried by the larger online book retailers, and Sturgeon was the subject of an interview on the November 10, 2005, airing of the *Marketplace Morning Report* radio program. The book has made it at least to the edge of the mainstream and is being marketed to the traditional publishing houses for a rewrite and reprint. If Sturgeon is successful in this effort, then perhaps he will add a new chapter on the befuddling words and phrases of the literary world (such as “tenpercentery”—the agency that takes a cut of an author’s earnings).

None of this is to take away from Sturgeon, who deserves credit for facing the daunting challenges that the publishing establishment presents to unknown authors. Perhaps now that same publishing establishment will help deliver on the book’s promise. Until then, despite its flaws, *Green Weenies* is one of the few references that attempts to translate the mysterious slang of the business world, and is worthy of consideration for anyone who spends time with people with business degrees.
The Future of Voice over Internet Protocol

ONE INDICATION that VoIP is the future of telecommunications is the recent surge in Internet searches for Voice over Internet Protocol. Another is that 40 percent of medium-to-large U.S. companies with PBX systems have already deployed VoIP equipment. These companies are seeing value in transporting voice over the Internet to reduce telephone and fax costs. VoIP also allows for video teleconferences and virtual offices, and it offers less complex management of the communication system of an office, fewer network elements to support across multiple locations, and fewer IT systems to support a firm’s communications media.

This does not mean, however, that—to choose one example—faxes are going to disappear. E-mail has not replaced the fax, and the fax continues to be a bedrock of interoffice communication. What VoIP can change is the manner in which faxes are received, sent, and printed. The fax machine is likely to see much less use. With VoIP, an office can take another step forward toward integration of its computer system with the outside world.

As with most technologies, three basic questions concerning VoIP are: “What is it?” “Why should we change?” and “How much will it cost?” The answer to the first question is that VoIP integrates telephony to a greater extent than before into an office’s Internet computer system. Reasons to change to VoIP include reduction of operating costs and enhancement of such communications features as video teleconferencing.

For VoIP to work, an office must have a broadband connection—whether cable or DSL—with enough bandwidth to handle the extra traffic of streaming video and voice transmissions. The major phone companies are in a mad dash to replace their current infrastructure of copper wiring with fiber optics to cope with the increasing demand for bandwidth. Assuming that an office has access to sufficient bandwidth, the next item on the checklist of needs is a router that is capable of handling voice and video streaming. New developments in technology may soon make the router obsolete and allow voice and video signals to flow more freely through an office computer system. For now, however, a router is needed.

Once the VoIP system is established at an office, there are four general means of sharing the flow of network traffic. First are IP phones. Second are analog phones, which are sitting on most office desks currently. Third are communication servers, and fourth are the necessary software programs. IP phones and servers are the best and most expensive solution. Analog phones with software programs that manage voice and data are the best solution for smaller offices or budgets.

VoIP vs. Analog

Most users do not appreciate that there is a significant difference between a true IP phone system and one that uses standard analog phones. One difference is obvious: A true VoIP phone system is not cheap. A router costs more than $3,000 and each IP phone $400. The cost can be justified, however, for large companies that use PBX telephone systems. Voice quality may also suffer, and even at its best does not surpass analog telephony. Organizations that already have high-speed data networks may find that the demands for voice and video will force significant investment in new equipment. Even when these expenses are recovered because of improvements in efficiency, the initial outlay can be daunting.

Internet and network traffic can hamper a VoIP system, generating background noise, echo, delay, clipping, coding errors, and mis-

The return on investment comes from the streamlining of voice and data transmission into a more unified system.

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Analog phones without a server and software to take advantage of VoIP will provide only some of the benefits of VoIP, such as lower monthly phone bills and fax via Internet. It is important to know what the different VoIP options and costs are.

Ease of Use

No matter what type of VoIP system a firm installs, the basic improvements include autodialing, fax over IP, and integration of e-mail and voice mail. When IP phones, servers, and VoIP software are used, these features are only the beginning. Autodialing is available with the right data and voice modem setup, but historically few users have taken advantage of it. VoIP makes autodialing simpler, thus increasing the likelihood that users will use it and save considerable amounts of time.

Fax over IP, or FoIP, is another preexisting feature that VoIP makes more practical. An office can create a document that remains digital even as it is transmitted to a destination. The time spent printing a document and then faxing it can be saved (as well as the time that may be spent retyping the document once it arrives at its destination and revising the document when it returns from its destination). Another benefit of VoIP is that users can send voice mail and video telephone calls through e-mail systems. Audio and video messages can even be forwarded to cell phones and pocket PCs. With VoIP, one can send a short video to a client instead of a typed message. This has significant ramifications for marketing and personal communication.

VoIP also offers a virtual network. Calls, faxes, databases, and videos can be shared among computers or other devices on a network for free or for the cost of a local phone call. Telecommuting has been made much easier with VoIP. Free video communication between users, no matter their location, is practical. With enough bandwidth and a communications server, video teleconferences can be held between departments, anywhere. With a Bluetooth headset, VoIP can connect home, office, and car. There are USB devices that can turn a VoIP network phone system into a wireless network. Users can keep their hands on the wheel or keyboard instead of having to hold a telephone with their shoulders all day.

VoIP is here in a big way. A system administrator will appreciate the functionality and control of a VoIP network. Managers considering budgets will find significant savings in costs and improved productivity. Marketing departments will find that the integration of voice and video with e-mail is a valuable marketing tool. Already off to a good start, VoIP is likely to become a must-have over the next two years.
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ON THURSDAY, JANUARY 26, the Los Angeles County Bar Association will present appellate attorney Daniel U. Smith and California Court of Appeal Justice Earl Johnson as leaders in a workshop on persuasive legal writing. The course shows how to persuade a skeptical judge by creating headings, paragraphs, and sentences that embody brevity, simplicity, and clarity. The course offers key steps for easy drafting and effective editing.

Attorneys at all experience levels will benefit from this program, which provides three hours of specialization credit in appellate practice. The program will take place at the LACBA/LexisNexis Conference Center, 281 South Figueroa Street, Downtown. Reduced parking is available with validation for $9. On-site registration and the meal will begin at 5:30 P.M., with the program continuing from 6 to 9:30. The registration code number is 009203. The prices below include the meal.

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For a full listing of this month’s Association programs, please consult the County Bar Update.
The Overreaction to the *Kelo* Decision

**THE RECENT DECISION** of the U.S. Supreme Court in *Kelo v. City of New London,* which held that commercial economic development can constitute a “public use” for which eminent domain may be exercised, touched off a firestorm of controversy. Following extensive negative media coverage and consumer polls, anti-*Kelo* legislation was launched and is wending its way through Congress and a number of states, including California. The *Kelo* decision will have little or no effect in California because of statutes already in place here, but the impassioned legislative reaction to *Kelo* may threaten the ability of California redevelopment agencies to eliminate urban blight.

The 5-4 *Kelo* opinion upheld New London, Connecticut’s economic redevelopment plan, which called for the potential use of eminent domain to revitalize the economically depressed town by creating community improvements, including commercial and retail space.

The outcome in *Kelo* was not surprising, because the Supreme Court has historically upheld legislative determinations of public use if they had a rational relationship to a conceivable public purpose. In *Berman v. Parker,* the Court upheld a comprehensive urban renewal plan that allowed the condemnation and transfer of property to private developers. In *Hawaii Housing Authority v. Midkiff,* the Court validated Hawaii’s decision to seize lands from landlords and sell them to tenants as a remedy for Hawaii’s concentrated land ownership, which had its roots in Hawaii’s original feudal land system.

Although Justice Sandra Day O’Connor authored *Midkiff,* she wrote the principal dissenting opinion in *Kelo.* She stated that the power of eminent domain should be reserved for transfers of private property to 1) public ownership (for roads, hospitals, and the like), 2) private ownership for public use (such as public utilities and stadiums), or 3) private ownership to remedy a prior harmful use (such as blight resulting from extreme poverty or an oligopoly resulting from extreme wealth).

The negative public reaction to *Kelo* was spurred by the fact that the petitioners were longtime homeowners whose individual properties were not blighted. Also, the press gave little attention to the other side of the eminent domain equation—the provision of just compensation. The fear conjured up in *Kelo’s* aftermath led to the introduction of much ill-considered legislation that is simply unnecessary in California.

**A Solution to the Solution**

As a federal district court found no support for an agency’s finding of “avoidance of future blight” when it condemned an unblighted retail property for use by another retailer. Justice O’Connor’s fears that “[n]othing is to prevent the State from replacing any Motel 6 with a Ritz-Carlton, any home with a shopping mall, or any farm with a factory,” are not justified in California.

Nevertheless, at this writing Congress has passed H.R. 3058, which prohibits use of federal funds to condemn property for economic development if the redevelopment project “primarily benefits private entities,” unless the project will remedy brownfields or “immediate threats to public health and safety.” Also, if proposed H.R. 4128 passes, local entities will lose two years of federal funding if they condemn property for private ownership for purposes other than the removal of immediate threats to public health and safety.

These “solutions” would substantially throw out redevelopment law rather than confront the effectiveness of the safeguards already built into California law. Because of the CRL, *Kelo* should not have an impact in California. Poorly conceived legislation only harms the ability of agencies to redevelop truly blighted lands through cooperative efforts with private parties.

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4 HEALTH & SAFETY CODE §33030.
5 *Sweetwater Valley Civic Ass’n v. City of Nat’l City,* 18 Cal. 3d 270, 277 (1976).

Vicki E. Land is a shareholder and Andrew J. Sokolowski is an associate of Brown, Winfield & Canzoneri, Inc. Land specializes in environmental and eminent domain matters and is the chair of the LACBA Condemnation and Land Valuation Committee. Sokolowski’s practice encompasses general commercial and real estate litigation.
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