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DAVID SPRANZA PAYS ATTENTION

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Greetings,

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Many months are officially dedicated to good causes. I would like to name February as Be Kind to Tax Professionals month. February is the start of the tax season, and clients will be very kind to their tax professionals by getting their tax information to them as soon as possible. Now is the time.

Providing tax records, however, is just the start. Tax return preparers are now subject to stricter standards when preparing clients’ tax returns. In past years, tax return preparers could take a position on a tax return without having to adequately disclose (and thus highlight) the nature of the controversy as long as the position had at least a “realistic possibility” of succeeding, which meant a one-third chance of success on the merits. Now, preparers can do so only if it is more likely than not that the position will succeed. And the level for adequately disclosed positions has increased from “not frivolous” to a “reasonable basis.” The new rules also expand the types of returns to which these standards apply, who is a tax return preparer, and the penalties for failure to comply.

These rules represent a fundamental change that will likely require return preparers to more closely scrutinize tax issues. They bring the return standard for undisclosed positions in line with the standard that lawyers follow when giving opinions that a tax position should be upheld. In the past, some practitioners may have relied on the lower filing standards for tax returns when structuring transactions. Many of these transactions are based on distinctions without a difference, multiple technically correct steps with incorrect results, or implausible assumptions. Tax return preparers are not to blame, but requiring the higher return standards should help.

The new return standards are just another example of rule tightening following the Enron debacle. Having seen a number of proposed transactions based on aggressive tax positions, I am amazed that some professionals who have spent years mastering the complexity of our tax laws could devote their time to such endeavors without realizing that they have gone too far. But tax professionals face a lot of pressure to find ways to reduce tax liabilities and sanction transactions that promise tax savings. Despite this, I believe it is the tax professional’s responsibility to say no when necessary. Our first loyalty as lawyers and accountants is to our ethical standards, and by applying these standards, we protect not only our clients but also ourselves. In recent years, complex and ultrasonicated tax structures that may have been technically correct in each aspect have brought down accounting and law firms alike.

This is not to be confused with discouraging clients from seeking tax benefits that our tax laws offer or shying away from justifiable positions. It is the job of tax professionals to advise clients on how to structure transactions so they do not needlessly incur tax liabilities. The tax code provides many valid tax incentives, and tax professionals should help clients take full advantage of them.

So this tax season, be sure to get your information to your tax professional early so he or she will have time to address the positions you take on the return. Remember that you, as the taxpayer, are ultimately responsible for those positions. If your tax return preparer advises you that you cannot take certain positions because they are not likely to succeed, instead of getting angry, you should be grateful because, in the long run, he or she may be doing you a great favor.

Chad C. Coombs is a shareholder in the Los Angeles office of Buchalter Nemer, APC, where he specializes in tax law. He is the chair of the 2007-08 Los Angeles Lawyer Editorial Board.
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Using a UDRP Action to Prevent Infringing Uses of Domain Names

THE UNIFORM DOMAIN NAME DISPUTE RESOLUTION POLICY (UDRP) provides an efficient, online process for trademark owners to redress the infringing use of Internet domain names. Participation in the UDRP process is mandatory for registrars of the most common types of domain names—those ending in .com, .net, and .org—when an action is initiated by a complainant who believes that the registration and use of a domain name conflicts with the complainant’s trademark rights.

To prevail under the UDRP, the complainant must prove 1) the complainant had a valid trademark at the time the respondent registered the allegedly infringing domain name, 2) the respondent’s domain name is identical or confusingly similar to the complainant’s trademark, and 3) the respondent registered and used the domain name in bad faith.

UDRP arbitration is simpler, faster, and less expensive than litigation, which can take years to resolve. A UDRP action generally involves the online filing of a single, comprehensive pleading with one of three ICANN-approved dispute resolution service providers: the World Intellectual Property Organization (WIPO), the National Arbitration Forum (NAF), and the Asian Domain Name Dispute Resolution Centre (ADNRC). Service providers charge administrative fees ranging from $1,000 to $7,000, depending on the number of domain names at issue and the size of the administrative panel. No discovery or motion practice is permitted, no hearing or trial is required except in “exceptional circumstances,” and decisions are often rendered in as little as 45 days after a complaint is filed.

A significant advantage of UDRP arbitration over litigation in federal court is the ability to circumvent barriers to obtaining personal jurisdiction over foreign defendants. All registrants of domain names ending in .aero, .biz, .cat, .com, .coop, .info, .jobs, .mobi, .museum, .name, .net, .org, .pro, .tel, and .travel are subject to the UDRP, no matter where the registrant is physically located. In addition, a number of national domain name registraries have adopted the UDRP. Thus, the UDRP may allow trademark owners to take action against foreign respondents who otherwise would be unreachable—or reachable only at great expense—in the United States. A comprehensive list of national registratories that have adopted the UDRP is available at http://www.wipo.int/amc/en/domains/rules/cctld/index.html.

Several limitations of the UDRP should be considered when weighing the benefits of arbitration against filing suit in federal court. First, the UDRP requires proof that the respondent acted in bad faith, whereas federal claims of trademark infringement and dilution do not. Bad faith can be shown by demonstrating circumstances indicating that the respondent: 1) registered or acquired the domain name primarily for the purpose of disrupting the business of a competitor, or 4) used the domain name for commercial gain by attempting to divert Internet traffic to the respondent’s Web site by creating consumer confusion with the complainant’s trademark.

Second, damages are not available to the prevailing party pursuant to the UDRP, whereas federal statutes prohibiting trademark infringement, trademark dilution, and unfair competition provide for awards of actual damages, costs, and (in some cases) treble damages and attorney’s fees. In addition, pursuant to the Anticybersquatting Consumer Protection Act, 15 U.S.C. Section 1125(d), a plaintiff can seek statu-

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practice tips

BY JUSTIN M. GOLDSMITH AND CASSANDRA L. SETO

Keeping Private Arbitrations Private

LAWYERS ARE REGULARLY CALLED UPON to advise clients whether to litigate or arbitrate disputes. The choice involves many factors, not the least of which is whether a particular client’s interests are best served by keeping a dispute out of the public eye. Most parties choosing to arbitrate anticipate that privacy will be one of the principal advantages. The world of private dispute resolution is ostensibly a controlled environment in which the public’s right of access to information does not apply. This can be a particularly important consideration if the dispute involves a high-profile individual or sensitive information.

That privacy bubble, however, can easily be punctured once the arbitrator renders an award, and prevailing and losing arbitral parties request a court to confirm or vacate it. Confirmation of an award results in a court judgment, without which the prevailing party cannot use all tools available for enforcing the award. The court filings required to seek relief can effectively force a once private proceeding into public view. Parties can ask the court to restrict public access to their filings, but with ever-tightening rules for sealing court documents, keeping private and sensitive arbitral information out of the public record is becoming increasingly difficult.

When privacy is a concern, counsel must keep this aspect of the arbitral endgame in mind while drafting an arbitration agreement as well as during an arbitration proceeding. Doing so can improve the chances of avoiding postarbitration court proceedings altogether or, at the very least, position counsel to present the best possible argument for sealing court records.

Limits of Arbitral Privacy

With court dockets jammed, public policy continues to favor private dispute resolution procedures. The California Legislature has declared that “greater use of alternatives to the courts, such as...arbitration should be encouraged” to achieve more effective and efficient dispute resolution in a complex society. Arbitration has been “praised by the courts as an expeditious and economical method of relieving overburdened civil calendars...” and as an accepted and favored method of resolving disputes.

From a litigant’s perspective, one of the primary reasons for entering the arbitral process is to handle disputes in a private setting: “Beyond arbitration’s traditional carrots of relative speed and greater economy, privacy is the other leg in this troika of features.” Parties A and B may not want their business affairs laundered in public (e.g., trade secrets, processes, procedures, methods, etc.). Protecting parties’ legitimate expectations of privacy can only encourage the use of arbitration as a method of dispute resolution.

Yet lawyers and clients must still bear in mind the limits of arbitration. However formal an arbitration hearing may be, the arbitrator’s ultimate award is not the equivalent of a court judgment. The award amounts to a contract between the parties. That contract can be challenged by the losing party on limited grounds through a petition to vacate. The prevailing party, on the other hand, can request the court to enter judgment consistent with the award through a petition to confirm. Obtaining a judgment allows the prevailing party to enforce the award against the losing party through contempt proceedings, debtor examinations, property seizure, and all other enforcement procedures available to judgment creditors.

An unanticipated byproduct of these postaward court procedures, however, can be the undoing of the privacy the parties expected when agreeing to arbitrate in the first place. To seek court confirmation, parties have to disclose their identities, the existence of a dispute, and even those limited disclosures can prove troublesome from a public relations perspective.

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closures can expand substantially. For example, among the permissible grounds for challenging an award under California law are allegations that the arbitrator improperly refused to hear material evidence or that the arbitration process was somehow corrupted. Either of those arguments will necessarily involve discussing the substance of the underlying proceeding. Any last shred of privacy can then vanish.

Sealing Court Records

In an effort to maintain the confidentiality of the arbitral process, parties can ask the court to seal records regarding the arbitration. On its face, such a request certainly seems justified given an individual’s right to expect that private personal or business information will be protected. In practice, however, the process is not that simple. Any request to seal records must overcome the general presumption in favor of public access to judicial records and proceedings. That presumption is based on the policy that public access to the courts fosters the appearance of fairness, which is essential to maintaining confidence in the judicial system.

The particular standards for sealing records vary from jurisdiction to jurisdiction, but parties must generally show that 1) a sufficiently strong interest for the sealing order exists, and 2) no less restrictive means for achieving that interest is available. In some instances, courts have found it is not enough that the parties express a mutual preference for sealing, or that the information could generally be embarrassing if publicly disclosed. Some courts have even held it is not enough that the records were only exchanged during arbitration based on an agreement between the parties to keep them confidential. Typically, parties must make some showing of an overriding interest—whether in the form of a proprietary business interest in the information, some potential compromise of the judicial process that would occur as a result of disclosure, or some other sufficient reason.

Moreover, even a successful sealing application might fail short of preserving a party’s complete expectation of privacy. Sealing orders must be narrowly tailored, and as a result a court may permit certain documents to be filed under seal but not the entire petition to confirm or vacate. For a party seeking to keep disputes entirely out of the public eye, such half-measures can prove problematic.

The bar that litigants must clear to convince a court to seal records has only gotten higher over the past decade, and that has resulted in an increasing tension between competing public policies. On the one hand, encouraging the use of alternative dispute
procedures such as arbitration is in the public interest. Preserving arbitral parties’ legitimate expectations of privacy—not just during the arbitration itself but also during necessary postaward court proceedings—can only serve that public interest. On the other hand, open access to court records is also in the public interest.

Predicting how any particular court will maneuver through this intersection of public interests is impossible. Some judges may acknowledge that preserving the privacy of arbitral parties constitutes an overriding interest sufficient to justify a sealing order. Other courts may not. Illustrating the latter view, one New York court observed, “Court records are presumptively open for public inspection and parties should not assume that their proceedings are presumptively sealed.” Courts have obligations to the public that private arbitrators do not.”

Precautionary Steps

Lawyers and clients should be cognizant of potential postaward proceedings when considering arbitration. They should think ahead and prepare to fight if they want to keep information about arbitrations out of the public record. Counsel should consider several measures when privacy is a priority.

• The parties can include a confidentiality provision in the arbitration agreement. This is the most obvious and commonly used precautionary measure. At the very least, a confidentiality provision can provide some assurance that each party will make a concerted effort not to publicly disclose information exchanged during an arbitration. Adding a complimentary liquidated damages provision can improve the likelihood of compliance.

Confidentiality language also generally signals the parties’ mutual interest in preserving privacy. This can secondarily benefit efforts to obtain a sealing order in any related court proceeding.17 Absent a confidentiality provision, one or both of the parties can also seek a protective order during the arbitration to achieve the same effect.

• The parties can stipulate to seal all records exchanged during arbitration. The parties can agree ahead of time that they will cooperate in any court proceeding to protect the confidentiality of information disclosed during arbitration. If possible, the best time to secure this commitment is at the agreement-to-arbitrate stage, but it can also be done to great effect during arbitral discovery.18 In crafting the stipulation, counsel should be sure to consider which court will have jurisdiction to enforce it and include language that tracks the applicable sealing standard.

• The parties can include provisions in the arbitration agreement that encourage voluntary compliance with an arbitration award. The best way to avoid disclosure through court filings is by avoiding court altogether. If privacy is a high priority, counsel should consider including incentives and disincentives in the arbitration provision to encourage voluntary compliance with an arbitration award and thereby obviate the need for judicial involvement.

One example is a fee-shifting clause for any postarbitration proceeding. Under this type of provision, compliance with the arbitrator’s award would be mandatory within a set period of time. Absent timely compliance, the losing party would be obligated to reimburse the prevailing party for all attorney’s fees and costs attributable to a successful confirmation petition or a successful opposition to a petition to vacate.

• The parties can agree to waive or limit the right to challenge an arbitration award as part of an arbitration provision.19 Even though the grounds for challenging an award are generally limited, this step involves significant risk. The right to challenge an award constitutes an important protection against fundamental arbitrator misconduct and should not be surrendered lightly. Moreover, a challenge waiver does not, on its own, guarantee an avoidance of court involvement. Arbitration awards still cannot be enforced without court confirmation, so without some other incentive for the losing party to voluntarily comply with the arbitrator’s ruling, court intervention could still be required. For that reason, counsel may consider coupling any challenge waiver with a fee-shifting provision for postaward proceedings.

• The parties may include a forum selection clause in the arbitration agreement. Assuming that state law governs the dispute,20 counsel should consider including a forum selection clause in the arbitration agreement identifying a state with more permissive sealing laws and less media presence.21 A forum selection clause will be considered valid and enforceable as long as the selected forum bears a “logical nexus” or “reasonable connection” to the parties or the dispute.22

• The parties and their counsel can exercise discretion during the arbitration. There may be times when highly sensitive information is helpful but is also cumulative of other nonsensitive information. In evaluating whether to use the more sensitive information, counsel should keep in mind the risk that it could later be made public.

• Counsel should be prepared to vigorously argue for a sealing order. Even if the parties agree that court records ought to be sealed, counsel should still anticipate resistance from
the court, or perhaps even from the press. Counsel should therefore treat joint sealing applications as though they are contested by outlining in as much detail as possible the legal and factual support for a sealing order. Taking some or all of these precautionary steps still cannot guarantee that private arbitrations will remain entirely private. But thinking ahead in these and other ways can help counsel and clients dramatically increase their chances of keeping private information out of the public record.  

1 Bos. & Prof. Corp. §§465(b), (d).  
10 See Vison v. Superior Court, 43 Cal. 3d 833, 841-43 (1987) (Under California Constitution art. I, §1, parties have a right to expect that information about their personal relationships will be protected); see also Fuls v. Superior Court, 88 Cal. App. 3d 899, 903-05 (1979) (same). The California Constitution also ensures that parties’ sensitive financial information will remain private. See Valley Bank of Nev. v. Superior Court, 15 Cal. 3d 652, 656-57 (1975); Moskovitz v. Superior Court, 137 Cal. App. 3d 315, 316-18 (1983). This right to privacy of financial affairs extends to business entities, particularly when the entity is a closely held corporation or partnership identified with a single individual or small group of individuals. See Ameri-Med. Corp. v. Workers’ Comp. Appeals Bd., 42 Cal. App. 4th 1260, 1287-88 (1996); Schnabel v. Superior Court, 5 Cal. 4th 704, 718 (1999).  
12 See, e.g., Cal. R. Ct. 243.1; NBC Subsidiary (KNBC-TV) v. Superior Court, 20 Cal. 4th 1178, 1204 (1999); Advisory Committee Comm. to Cal. R. Ct. 2.550 (basing California’s sealing rules on the “overriding interest” standard articulated in NBC Subsidiary).  
13 See Foltz v. State Farm Mut. Auto. Ins. Co., 331 F. 3d 1122, 1131 (9th Cir. 2003) (holding that parties’ mutual agreement does not dispense with the court’s duty to make an independent determination of whether good cause exists for sealing the record); In re Neal, 461 F. 3d 1048, 1054 (8th Cir. 2006) (“[I]njury or potential injury to reputation is not enough to deny public access to court documents.”).  
15 See SmithKline Beecham v. Pintech Pharmas., 261 F. Supp. 2d 1002, 1008 (N.D. Ill. 2003) (holding that even when an overriding injury has been shown, only the particular provisions that need to be kept confidential should be sealed).  
16 In re [Sealed], 64 F. Supp. 2d 183, 184 (E.D. N.Y. 1999). As a policy matter, it will likely be easier to argue for a sealing order in the context of a purely private arbitration. The interest in allowing public access to information is greater when the dispute involves a risk to public health or safety.  
17 See Universal City Studios, 110 Cal. App. 4th at 1283 (noting that “a binding contractual agreement not to disclose,” by itself, could constitute “a potential overriding interest” justifying sealing the record); Commercial Union Ins. Co. v. Lines, 239 F. Supp. 2d 351 (S.D. N.Y. 2002) (granting motion to seal in part because the arbitration was conducted pursuant to a confidentiality agreement); West v. West, 1998 WL 894594, at *2 (9th Cir. Dec. 7, 1998) (finding that, under confidentiality provision, party should have filed motion to confirm arbitration award and supporting documents under seal).  
18 See DiRusso v. Dean Witter Reynolds Inc., 121 F. 3d 818, 826 (2d Cir. 1997) (approving “sealing the file” when “a confidentiality agreement...entered into by the parties during the discovery phase of the arbitration required that the papers...submitted to the district court be placed under seal”).  
19 See Moncharsh v. Heiley & Blase, 3 Cal. 4th 1, 9-10 (1992) (explaining that even in the absence of an explicit challenge waiver, courts ensure that the parties receive the benefit of their contractual bargain by treating an arbitration award as final and binding); Pacific Gas & Elec. Co. v. Superior Court, 15 Cal. App. 4th 576, 588-89 (1993) (holding that because the scope of arbitration is a matter of contractual agreement, the parties can specify the form of judicial review).  
20 If federal law applies, the Federal Arbitration Act requires that the parties apply to the district in which the arbitration award was made for confirmation or vacatur. 9 U.S.C. §9.  
21 Privacy concerns need to be weighed against convenience to the parties, the favorability of a forum’s substantive law, and other factors generally considered in evaluating potential forum selections.  
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Choice of Law Disputes in Insurance Litigation

**LITIGATION OVER INSURANCE CONTRACTS** often involves complicated choice of law issues. Often, the insurer and insured will be from different states. Occasionally, they are from different countries. Further complications may arise if the loss occurs in yet another jurisdiction. To make matters more complex, insurance contracts usually do not include a choice of law clause. For example, a New York insurer may issue a commercial general liability policy to a California corporation with nationwide activities. An accident—a potentially covered loss—may occur in another state, say Nevada. It may involve a third-party plaintiff from yet another state—say Utah. Finally, the underlying suit may be filed against the insured in yet another jurisdiction, say Texas.

Deciding the law applicable to this case may be hard enough—after all, in the example, the plaintiff is from Utah, the defendant is from California, the accident occurred in Nevada, and the suit is filed in Texas. In the insurance litigation arising from the lawsuit, another layer of complexity is added, because the insurance suit involves a New York insurer that may have issued the policy in California through a California broker.

These facts may be much ado about nothing or may be crucial to the case. For example, the applicable state law may determine such issues as the applicability of the notice-prejudice rule, the insurability of punitive damages, or the existence of a bad faith tort. In these situations, a choice of law analysis will be critical to determining the existence of a claim and its value at trial or settlement.

California appears to have firmly adopted the judicially fashioned “governmental interest” analysis for determining choice of law issues, but the continuing existence on the statute books of an older rule leaves lingering tension. The older rule is found in Civil Code Section 1646. It is a supposedly bright-line choice of law rule that has been a part of the Civil Code since 1872 but has been little used since the adoption of California’s modern approach to choice of law problems. Under Section 1646, “a contract is to be interpreted according to the law and usage of the place where it is to be performed; or, if it does not indicate a place of performance, according to the law and usage of the place where it is made.”

Under the newer governmental interest test (the so-called modern approach), courts examine the allegedly conflicting laws and the underlying interests of the states involved, then apply (or choose) the law of the state whose interests would be most impaired by application of the other state’s law. The place of performance and the place where the contract was made are factors to be considered but are neither determinative nor as weighty as they are under the Section 1646 regime.

California thus has two different rules for choice of law analysis: One is a bright-line rule focusing on the place of performance (a somewhat ambiguous term in the context of an insurance policy) or the place where the contract is made, and the other is a methodology involving the weighing of competing governmental interests. For decades, it seemed that Section 1646 had been eclipsed by judicial holdings applying the governmental interest test, although courts occasionally have noted the tension between the two rules.

**Frontier Oil**

The Second Appellate District—a panel including no less an authority on insurance than Justice H. Walter Croskey—recently stirred up this pot. In *Frontier Oil Corporation v. RLI Insurance Company*, a Texas-based insured alleged that its Texas insurer had to defend it in a California case alleging injuries arising out of the insured’s oil and gas drilling operations in California. The court was asked to determine two main questions: Did an endorsement include a duty to defend, and was the duty to defend triggered by the underlying case? The insurance policy at issue was entered into in Texas. The court made several key holdings.

First, the court held: “[W]e are unable to conclude that California has ‘judicially abrogated’ the express legislative mandate of Civil Code Section 1646 relating to interpretation of contracts.” However, the court clarified that Section 1646 applies only to issues of policy interpretation, while the governmental interest analysis applies to all other issues. The court reasoned that the first issue in the case—whether the endorsement included a duty to defend—involved interpretation of the endorsement in light of other language in the policy, so choice of law was determined under Section 1646.

Second, the court analyzed the meaning of “place of performance” as used in Section 1646 in the context of an insurance policy. The court reasoned that the policy indicated “a place of performance” of the duty to defend in California, since the parties clearly intended to cover certain insured operations in California, and “anticipated that a suit arising from those operations in Beverly Hills could be prosecuted in California and that RLI would be obligated to provide a defense in California if the claims were potentially covered under the policy.” As a result, although the contract was entered into in Texas between a Texas insurer and a Texas-based insured and included endorsements conforming the policy with Texas law, the court found

Several points emerge from a review of the *Frontier Oil* court’s scholarly engagement with the applicable choice of law rules in California and with the somewhat tangled history of Section 1646.

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California law applicable to this initial interpretive issue under Section 1646. That holding appears to signal that different interpretive rules may apply to the same policy depending on where the particular insured risk is located.

Finally, the court noted that the second main issue—whether the duty was triggered by the assertion of potentially covered claims—may involve more than interpretation, meaning that the governmental interest analysis would provide the applicable choice of law regime. However, the court refused to decide the issue squarely, since Section 1646 and the governmental interest analysis pointed to application of the same law. Reviewing the state of the law, the court pointed out several issues that have arisen in insurance disputes that do not involve interpretation—for example, whether the insured may recover attorney’s fees when it successfully sues its insurer for a defense, or whether an insured may obtain coverage for punitive damages. Since these are not questions of interpretation of the policy, the court suggested that Section 1646 would not apply to these issues; the governmental interest analysis would apply instead.

Several points emerge from a review of the Frontier Oil court’s scholarly engagement with the applicable choice of law rules in California and with the somewhat tangled history of Section 1646:

- The applicable choice of law analysis may depend on whether an issue is an interpretation issue or some other sort of issue—for example, an issue involving public policy judgments between jurisdictions about requirements imposed on insurance contracts.
- The “place of performance” of defense obligations is “the jurisdiction where the suit is prosecuted.” This raises a few questions. What if suit is prosecuted in a state different from the one where the insured risk is located? What about indemnity obligations? Would Section 1646 require application of different state laws depending on whether the interpretation issue involved the defense obligation or the indemnity obligation?
- The location of the insured risk appears to continue to play a very significant role in determining choice of law under either analysis.

The Second District’s attempt to clarify this area of California law is welcome. The U.S. District Court for the Southern District of California, writing in 1963, aptly characterized the uncertainty under Section 1646, noting that “nothing but a bewildering confusion would result from any attempt to reconcile all of the California cases applying [Section 1646] to conflicts of law questions involving insurance contracts wherein it is provided that premiums are to be paid at the home office of the insurance company or to an
authorized agent of the company, and the contract is made in State A, but most of the premiums are paid in State B."16

Confusion has multiplied since then, with the adoption of the “modern” approach to choice of law and the consequent uncertainty about which approach to apply. With Frontier Oil, the Second District has delineated a sphere of influence for each rule. Whether the California Supreme Court and the Ninth Circuit will ultimately agree with this approach remains to be seen.

1 This rule relates to whether the insurer must show prejudice in order to defeat a late-filed claim.
2 Insofar as the forum rules on choice of law apply, a critical prefiling step is determining which forum offers a choice of law rule most likely to result in application of favorable substantive law. For example, because of the applicable choice of law rules in States A and B, filing in State A might result in application of State B’s substantive law, while filing in State B might result in application of State A’s substantive law. If State A’s substantive law is preferable, it might be wise to consider filing in State B.
3 In addition, with regard to certain insurance contracts, California courts have looked to Restatement (Second) Conflict of Laws § 193, which provides that, with regard to “fire, surety and casualty” policies, the “location of the insured risk will be given greater weight than any other single contact in determining the state of the applicable law.” Stonewall Surplus Lines Ins. Co. v. Johnson Controls, Inc., 14 Cal. App. 4th 637, 645 (1993); Ford Motor Co. v. Insurance Co. of North Am., 35 Cal. App. 4th 604, 614 (1995).
5 California’s governmental interest test is also known as the comparative impairment test.
6 There are many places where a CGL policy may be performed, since there are many performances due under the policy, including where premiums are paid, where the policy proceeds are to be paid, and where a defense is provided.
10 Id. at 1459.
11 The court based this finding on the specific reference in the policy to operations in California, including endorsements adding the city of Beverly Hills and the Los Angeles DOT as additional insureds. The court recognized an endorsement that “apparently conforms this policy issued in Texas with Texas law with respect to three specific areas, none of which is relevant to the issues raised in this appeal: (1) the ‘notice prejudice’ rule, (2) policy cancellation, and (3) policy renewal.”
13 The court noted that the imposition of a duty to defend based on the assertion of potentially covered claims appeared to be a matter of policy interpretation and public policy. Another issue involved whether the insurer must consider facts extrinsic to the complaint. The court found that §1646 and the governmental interest analysis applied to application of the same law, and so did not squarely determine which regime applied.
14 The court also left open whether a rule requiring an insured to consider extrinsic evidence in determining duty to defend was a rule of interpretation (so that §1646 would apply) or some other sort of rule (so that the governmental interest analysis would apply). Id. at 1464-67.
15 Id. at 1460 (discussing Robert McMullan & Son, Inc. v. United States Fid. & Guar. Co., 103 Cal. App. 3d 198 (1980)).
16 Id. at 1460-61 (discussing Stonewall Surplus Lines Ins. Co. v. Johnson Controls, Inc., 14 Cal. App. 4th 637 (1993)).
An unassuming commercial building known as the Jewelry Center, situated in an older section of downtown Los Angeles, seems an unlikely object of the attentions of real estate lenders and their counsel in a federal case. When the owner of the Jewelry Center defaulted on its loan secured by a deed of trust on the property, the property was sold to the foreclosing lender at a nonjudicial foreclosure sale. Shortly thereafter, the lender also sued the borrower to recover damages for bad faith waste to the property caused by the borrower during its ownership of the property. This attracted attention because California's antideficiency rules are usually thought to bar further loan recovery claims against borrowers following nonjudicial foreclosure sales. To support its claim for waste in the face of the antideficiency rules, the lender presented evidence of poor or deferred maintenance and service, numerous code violations, unsafe or illegal building conditions, failure to repair, and the borrower's pocketing of millions of dollars from rents and loans secured by the property. This, according to the lender, was not just “waste” but “bad faith waste” under California legal precedent—and the Ninth Circuit agreed. In an unpublished decision, D.A.N. v. Binafard, the Ninth Circuit held that the borrower was liable to the lender for losses resulting from diminution in the value of the collateral.2

Facts similar to those in this case are frequently in evidence in the current real estate market. Lenders are likely to increasingly face the decision of whether to pursue a borrower for committing waste to the collateral securing the loan. As aggregate loan losses mount for lenders, the pressure to increase

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recoveries will grow, and more lenders may take a second look at the heretofore infrequent claim of bad faith waste.

The concept behind the tort of bad faith waste was almost 30 years old by the time of the insightful Jewelry Center decision. Indeed, the distinction between waste and bad faith waste was created in 1975 by the California Supreme Court in *Cornelison v. Kornbluth.* The decision established the extent to which the traditional real property action for waste is available to creditors to recover diminution in the value of collateral following the sale of real property used as security for a loan, notwithstanding the protections of California’s antideficiency laws that would otherwise protect a debtor from being required to make payments to a lender following a nonjudicial foreclosure.

Armed with the bad faith waste doctrine, creditors of obligations secured by real property have a better chance of obtaining a deficiency judgment against a defaulting debtor when the debtor has—for reasons other than mere pressures of a falling market—caused diminution in the value of collateral through actual damage or lack of care while diverting profits. Moreover, a successful plaintiff claiming bad faith waste may be awarded punitive damages.

The traditional legal definition of “waste” involves conduct by the person in possession of property that impairs the value of the property, which serves as a lender’s security. Waste can either be by commission (often referred to as affirmative conduct)—which occurs when the possessor damages or destroys improvements on the property—or by omission—such as when the possessor fails to care for and maintain the improvements.

“Bad faith waste” is a term that describes the extent to which a Civil Code Section 2929 action for waste will be allowed to survive the application of Code of Civil Procedure Sections 580b or 580d (sometimes referred to collectively as the Antideficiency Law). Section 580b prohibits a deficiency judgment after any foreclosure sale, judicial or nonjudicial, of property that is securing a third-party purchase money mortgage on owner-occupied residential property or a seller-held purchase money mortgage on any kind of property. Section 580d prohibits a deficiency judgment following a nonjudicial foreclosure sale of real property.

In *Cornelison,* the plaintiff sold a single-family dwelling and took back a promissory note secured by a deed of trust on the property. Subsequently, the property was resold and ultimately condemned as uninhabitable. The original purchasers defaulted on the promissory note, and the plaintiff caused the property to be sold at a trustee’s sale. The plaintiff proceeded to purchase the property at the sale by making a full credit bid. The plaintiff then sued one of the original purchasers for waste.

The *Cornelison* court, after extensive review of the purpose of Section 2929 and the Antideficiency Law, first concluded that for purchase money loans, Section 580d barred recovery for waste committed “soley or primarily as result of the economic pressures of a market depression.” It also held that for nonpurchase money loans, Section 580d barred recovery “when the waste actually results from the depressed condition of the general real estate market.” Thus, it seemed that the *Cornelison* court would merely reinforce the Antideficiency’s Law’s preclusion of deficiency judgments. However, the supreme court proceeded to rule that the Antideficiency Law did not bar “recovery in actions for... bad faith waste.” The court defined “bad faith” in the context of bad faith waste as “reckless,” “intentional,” or “malicious” conduct. It also distinguished this type of waste from the neglect that occurs due to an owner’s financial inability to properly maintain his or her property.

Unfortunately, the court did not specify what specific acts might constitute bad faith, probably because the court elected not to decide whether the defendant in *Cornelison* was in fact liable for bad faith waste. Rather, the court upheld summary judgment for the defendant on the grounds that the lender made a full credit bid for the property at the foreclosure sale. By making a full credit bid, the plaintiff was made whole, thus eliminating any potential liability for bad faith waste.

**Parties to a Claim**

California law establishes that the plaintiff in a bad faith waste action may either be the mortgagee of the note secured by the damaged property or the beneficiary of a deed of trust for the damaged property. According to Civil Code Section 2929, “No person whose interest is subject to the lien of a mortgage may do any act which will substantially impair the mortgagee’s security.” That section applies equally to a deed of trust, since a mortgagee has a price paid for the property, which serves as a lender’s security. Therefore, any mortgagee or beneficiary of a deed of trust should have standing to bring a bad faith waste action.

Section 2929 imposes a duty not to commit waste upon any “person whose interest is subject to the lien.” This duty is imposed by law, independent of the covenants in the deed of trust, and it applies to any person in possession of the property, including the trustee, any successor of the trustee, and a vendeep in possession.

Courts have addressed the liability of parties in possession of the property serving as security in three specific instances: nonassuming grantees of the property, assuming grantees of the property, and nonrecourse borrowers.

A nonassuming grantee of property—one who purchases a property “subject to” the existing loan but does not assume the loan—can be sued for bad faith waste. The *Cornelison* court reasoned that although a nonassuming grantee is not personally liable on the debt, his or her interest in the property is subject to the lien. Therefore, pursuant to Section 2929, the court held that the nonassuming grantee has a duty not to commit waste. As a result, a nonasssuming grantee of property is a potential bad faith waste defendant.

Similarly, according to Weaver v. Bay, a case of bad faith waste may be made against an assuming grantee of property—one who becomes the principal debtor on the loan by expressly assuming the obligation. Although Weaver was decided before Cornelison, the Weaver court noted that damages for waste may be recovered against mortgagors for “failure of an enterprise through inept management, too high a price paid for the property, adverse economic conditions, and the like.” Moreover, it would not make sense for an assuming grantee of property to avoid the liability for bad faith waste that attaches to a nonassuming grantee since both are in possession of the property.

Nonrecourse borrowers are borrowers whose loan documents expressly provide that they have no personal liability on the debt. This group of borrowers also may be held liable for bad faith waste. Just as the nonasssuming grantee of property is not personally liable for a debt, nonrecourse borrowers are not personally liable for their loan obligations. According to the court in *Nippon Credit Bank, Ltd. v. 1333 North California Boulevard,* nonrecourse borrowers have a “special” responsibility to protect an asset they have pledged to another as the sole security for repayment of a debt: “[T]here are circumstances where a nonrecourse borrower should be liable for waste, including failure to pay real property taxes.” The court does not explain what makes the nonrecourse borrower’s relationship more special than that of any other borrower.

**Elements of Bad Faith Waste**

Although no single case has set forth the necessary elements for a bad faith waste action, these may be extracted from a review of relevant cases:

1. The defendant has or had a lien encumbering real property.
2. The defendant has or had possession of the
real property.
3) Waste was committed on the real property.
4) The waste on the real property was committed in bad faith.
5) The value of the real property was impaired as a result of the bad faith waste.22

As is often true with case law, judicial enumerations of the elements of this cause of action do not provide much in the way of specific guidance. Generally, in most cases, elements 1, 2, and 5 either will not be in dispute or will be readily provable without substantial confusion over the meaning of terms. Proving elements 3 and 4, however, requires further case study.

In the Binafard decision, in which the defendants were held liable for bad faith waste resulting from the failure to properly maintain a property,23 the building in question, the Jewelry Center, was subject to an $8 million promissory note secured by a deed of trust. Upon the default on the note, the Jewelry Center was sold at a nonjudicial foreclosure sale to the plaintiff for $100,000. Shortly after the sale, the plaintiff sued the defendants to recover damages for bad faith waste.24 The result in Binafard seems to suggest that a lender who can present evidence similar to the facts shown by the Binafard plaintiff will satisfy the requirement for the existence of waste.

Generally, waste requires physical injury to the real property, but there is also law to the effect that nonpayment of taxes may constitute waste as well.25 Of course, to maintain an action for bad faith waste, it is not enough that the waste is caused by a party. The waste must be committed in bad faith. The Cornelison court created a standard for bad faith waste to separate it from general neglect, but it did not provide examples—either by using the facts of the case or by employing more general descriptions. However, several other decisions have done so.

Courts have recognized that taking immediate financial advantage of the security with no regard to its resulting condition—also known as milking—is a form of bad faith waste within the meaning of Cornelison.26 A party seeking to show that its opponent has engaged in milking cannot merely present evidence that money was diverted from the property. The party must demonstrate the type of use made of the funds. In In re Mills, the trustee purchased a hotel. When the beneficiary of the purchase-money mortgage foreclosed six months later, many of the hotel rooms were uninhabitable because of poor sanitation, vermin infestation, and numerous violations of the building and housing codes.27 The evidence showed that the property had performed poorly financially but also that the trustee had diverted rental income to other properties that also had financial difficulties. The beneficiary of the mortgage spent $125,000 in rehabilitation expenses after the foreclosure sale.

The Mills court held that neither the mere failure to maintain the property nor the deterioration of the property due to the trustee’s financial difficulties constituted bad faith waste.28 The court noted, “We might well have [found bad faith waste] had the evidence shown that [the defendant] put little or no money into the hotel, attempting instead to milk it for as much cash as possible.” According to the court, the beneficiary had the burden of proving bad faith waste—and failed to do so.

In contrast to Mills, the court of appeal in Nippon held the defendant liable for bad faith waste. The debtor partnership failed to pay its tax bill on the property, choosing instead to pay twice that amount to the trustor, Nippon.30 The result in Nippon distinguished Mills by noting that the defendant in Mills had operated the property for only a few months and “lost the bulk of his investment,” whereas it appeared that the Nippon defendants did not lose their investment and, in fact, appeared to profit from the secured property.30

When the Ninth Circuit in Binafard found the defendant liable for milking,31 it observed that the defendants collected millions of dollars from rents and loans secured by the property at issue but failed to make any repairs other than those necessary to keep the structure open and operational. Citing Mills, the court noted, “Such ‘milking’ of the security has been recognized as a form of bad faith waste.”32 Thus, for a court to find a defendant liable for milking, it is not sufficient to simply establish that funds were diverted from the property provided as a security and were not used for the benefit of the security. A plaintiff also must establish that the defendant did not have a justifiable economic rationale for diverting the funds, and possibly the property became distressed in order to benefit the defendant.

Another argument raised by parties seek-
ing to avoid liability for bad faith waste is that neglect is an act of omission, not commission. Therefore, neglect is not a malicious or intentional bad faith act. Acts of omission, such as a failure to repair, are not bad faith acts. However, subsequent appellate court decisions have defined “waste” as conduct, by both commission and omission, on the part of the person in possession of the property that impairs the value of the lender’s security. A plaintiff can demonstrate bad faith waste by proving either that 1) a defendant diverted money from the property provided as security and made ill use of the funds (milking), or 2) a defendant substantially neglected the property that is the security for the loan.

What constitutes waste for the purposes of a bad faith waste action is determined by measuring detriment to the value of the secured property. The measure of damages for waste is the amount of the impairment of the security; that is, the amount by which the value of the security is less than the outstanding indebtedness and is thereby rendered inadequate.

The *Nippon* court also held that the “full amount” of the outstanding debt may include money the creditor has advanced for the unpaid taxes on the property used to secure its loan. In a real estate-secured loan with a traditional lender, advances to protect the collateral will likely also be addressed in the loan documentation. However, a bad faith waste claim gives lenders another avenue to recover these protective advances when the loan documents are deficient.

**Substantive Defenses**

Several defenses are available in bad faith waste actions. These include the financial insolvency of the debtor, a general decline in real estate values, acts of God, and a full credit bid extinguishing the loan obligation.

An action for bad faith waste may not be sustained when a defendant merely acts “out of inability to make ends meet financially” instead of recklessly, intentionally, or maliciously despoiling property. The *Mills* court held that the beneficiary has the burden of proving bad faith waste, but the evidence in that case merely showed a financial inability to maintain the property, not the recklessness and malice needed to support a bad faith waste claim.

The *Nippon* court suggested, in dicta, that the financial condition of the debtor might serve as a defense in a bad faith waste action if the alleged bad faith waste was the failure to pay property taxes: “There may be exigent circumstances which would justify a failure to pay real property taxes; for example, where a choice must be made between paying the taxes and making loan payments or necessary repairs, a tax default might merely rearrange the lender’s loss without increasing it.” However, the dissenting opinion in *Mills* expressed concern regarding a lack of precedent for a debtor’s specific financial condition (as opposed to one caused generally by a depressed real estate market) establishing a viable defense to allegations of bad faith waste: “We would expect any debtor seeking protection of the bankruptcy laws to be in a position of serious economic distress. *Cornelison* does not stand for the proposition that such individual circumstances alone can insulate the debtor from charges of bad faith waste.”

Moreover, the Ninth Circuit’s decision in *Binafard* restricted the scope of the economic necessity defense. The defendants in *Binafard* sought to submit evidence that they failed to maintain the building at issue because they lost a substantial sum of money invested in a second building. They claimed that they did not act in bad faith. The court of appeal upheld the district court’s exclusion of this evidence on the grounds that it would be prejudicial to the jury. The *Binafard* court distinguished the economic necessity defense allowed in *Mills* on the grounds that 1) the amount of money removed from the building at issue by the *Binafard* defendants would have been more than enough to prevent the waste and still allow the defendants to realize a return on their investment, and 2) unlike the defendant in *Mills*, the *Binafard* defendants had not made a capital investment that far exceeded the amount of money that they took away from the building.

The court in *Hickman v. Mulder* stated that a decline in the value of the security resulting from the depressed condition of the general real estate market would establish a defense to a bad faith waste allegation. Therefore, if a bad faith waste defendant could prove that the diminution in value of the property was due to depressed property values as opposed to waste, this evidence would serve as a viable defense, or at least a credit against damages. However, the fact that waste occurred during a depressed real estate market is not necessarily controlling. A determination must be made whether the waste was due to the depressed market conditions or as a result of the bad faith actions of the defendant. If the waste resulted from the defendant’s bad faith acts, the defendant would still be liable.

Damas caused by acts of God are not considered to be waste. In *Krone v. Goff*, the trustee failed to repair earthquake damage to the property and was sued for waste. The *Krone* court held that damages caused by a fire or earthquake are not a result of wrongful acts by the trustor and, therefore, the injury to the property did not constitute waste.

At a nonjudicial foreclosure sale in California, the lender-beneficiary is entitled, but not required, to make a credit bid for an amount up to the maximum of its indebtedness, since it would be pointless to require the bidder to tender cash that would only be immediately returned. If the beneficiary or mortgagee at a foreclosure sale enters a bid for the full amount of the debt plus the costs of sale and fees due in connection with the sale, the beneficiary or mortgagee cannot recover damages for bad faith waste. This is because there has been no impairment of the security, because the lien has been extinguished by the full credit bid. Similarly, if the property at issue were sold to a third party for the full amount of the debt plus the costs of sale, there would be no diminution of the security and, therefore, no waste. The court of appeal has distinguished between “outstanding indebtedness” and the amount secured by the senior deed of trust, holding that trust holders with both senior and junior liens in deed of trust property do not make a “full credit bid” when they bid only the amount that is secured by their senior deed of trust.

Actions for bad faith waste, while brought infrequently, enable secured creditors a better chance of obtaining deficiency judgments against defaulting debtors. Moreover, as with some other torts, successful litigants have an opportunity to recover punitive damages upon a proper showing. As the *Nippon* court stated, “[E]xposure to punitive damages may be as much a deterrent to bad faith waste as to any other tort.”

Counsel for potential plaintiffs should realize that waste is not just physical injury to the property. It may constitute any act of commission or omission that impairs the value of the property securing a plaintiff’s loan. However, before commencing any bad faith litigation, counsel should take care to see whether the acts of the potential defendant rise to the level of reckless, intentional, or malicious conduct necessary to argue that the impairment of the security constitutes bad faith.

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2. Id. at *3.
6. See, e.g., Hickman v. Mulder, 58 Cal. App. 3d 900, 909 (1976) (failure to irrigate, cultivate, fertilize, fumigate, and prune agricultural property constituted waste); Easton v. Ash, 38 Cal. 2d 530, 593 (1941) (cutting trees on property constituted impairment of the value of
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property used to secure debt). 7 CIV. CODE §2929.
8 Cornelison, 15 Cal. 3d at 594.
9 Id. at 604-05.
11 Cornelison, 15 Cal. 3d at 604.
12 Id. at 605.
13 CIV. CODE §2929 (emphasis added).
14 Cornelison, 15 Cal. 3d at 599.
15 Id. at 599 n.3. A mortgagor’s security interest can be impaired by harm to the property committed by third persons not in possession, and a mortgagor can recover damages in tort for this impairment of its security interest. However, the mortgagor’s recovery against third parties involves different considerations and rules because the person sued is not the debtor-mortgagor, who is afforded a variety of legislative and judicial protections. 4 H. MILLER & M. STARR, CALIFORNIA REAL ESTATE §10:53 (3d ed. 2006).
17 Cornelison, 15 Cal. 3d at 599. See also In re Mills, 841 F. 2d 902, 905 (9th Cir. 1988).
18 Mills, 841 F. 2d at 903.
19 Id. at 905.
21 Id.
22 Cornelison, 15 Cal. 3d 590; Nippon, 86 Cal. App. 4th 486.
24 Id. at *1.
25 See Nippon, 86 Cal. App. 4th at 497 (holding that trustee’s intentional nonpayment of an installment of real property taxes can constitute bad faith waste). 26 Id. at 497; see also In re Mills, 841 F. 2d 902, 905 (9th Cir. 1988).
27 Mills, 841 F. 2d at 905.
28 Id. at 907.
30 Id. at 907.
32 Id.
34 Cornelison v. Kornbluth, 15 Cal. 3d 590, 606 (citations omitted).
36 Id. at 497-98.
38 Id.
40 Cornelison v. Kornbluth, 15 Cal. 3d 590, 606 (citations omitted).
41 Nippon, 86 Cal. App. 4th at 497.
42 In re Mills, 841 F. 2d 902, 905 (9th Cir. 1988).
43 Id.
44 Nippon, 86 Cal. App. 4th at 497 (citation omitted).
45 Mills, 841 F. 2d at 906.
47 Id. at *3.
50 Id. at 194-95.
As the real estate market continues to cool throughout California, the number of real estate disputes has increased dramatically. This trend is not surprising. In downward real estate markets, buyers find reasons to break purchase agreements, disgruntled investors find reasons to sue developers, speculators default on loans, and partners differ on how best to preserve diminishing equity. When these disputes ripen into lawsuits, one of the first shots across the bow from seasoned litigators is the filing and recording of a lis pendens. A party asserting a claim to real property may record a lis pendens, which is a notice of the pendency of an action. The lis pendens serves as notice to prospective purchasers, encumbrancers, and transferees that litigation regarding the property at issue is being pursued. It gives constructive notice of the pendency of the action and causes the rights and interests of the claimant in the property to relate back to the date of the recording of the lis pendens. A lis pendens puts a cloud on title, effectively preventing a sale or encumbrance of the property until the litigation is resolved or the lis pendens is expunged. Under former lis pendens law, if a party filed a lis pendens for a “proper purpose and in good faith,” it could only be removed from title if the party against whom it was filed ultimately prevailed in the litigation. This standard was easy to meet and difficult to overcome—and it gave rise to serious abuses. Property owners who were unable to sell or refinance their properties would instead settle the litigation, regardless of merit, just to remove the cloud on title to their properties. To curb these abuses, in 1992 the California Legislature substantially revised the lis pendens law, and the revisions are still in effect today.

In recent years, several court decisions have interpreted the legislature’s revisions to the lis pendens law. These decisions establish
how courts should determine a real property claim. Also, they confirm that the improper recording of a lis pendens is no longer privileged and thus may give rise to liability for slander of title. In addition, attorneys are now responsible for insuring that the county recorder’s office timely and properly records a lis pendens—a malpractice trap for the unwary. Moreover, once a motion to expunge is filed, a moving party has no incentive to voluntarily withdraw a lis pendens because a court may still award attorney’s fees to the moving party.

Clearly the risks of recording an improper lis pendens are now greater than ever. Therefore, deciding whether or not to record a lis pendens requires knowledge and careful analysis of current lis pendens law.

**Real Property Claims**

Under the 1992 revisions to the lis pendens law, a party must show more than lack of ulterior motive and good faith to maintain a lis pendens. Instead, a court must expunge a lis pendens if it determines that the action does not contain a “real property claim,” or if the claimant fails to prove the probable validity of the real property claim by a preponderance of evidence. Unlike most other motions, the burden is on the party opposing the motion to expunge—that is, the real property claimant who recorded the lis pendens.

A motion to expunge for want of a real property claim pursuant to Code of Civil Procedure Section 405.31 is treated like a demurrer. The court must review the pleading to determine whether it states a real property claim, without review of the evidence. An evidentiary showing only comes into play if the property owner seeks to remove a lis pendens on the grounds that the claimant has not established the probable validity of a real property claim pursuant to Section 405.32. Under current law, even if a claimant shows the probable validity of a claim, courts must still order a lis pendens expunged if an undertaking would provide adequate relief for the claimant.

A “real property claim” is one “which would, if meritorious, affect title to, or the right to possession of, specific real property.” This seemingly clear language has given rise to differing interpretations. For example, prior to the 1992 revisions, courts disagreed over whether a claim for a constructive trust on real property affected title to or possession of real property. The majority of courts, concerned about the misuse of a lis pendens and the difficulty of its removal, held that a claim for constructive trust does not support a lis pendens “if, ultimately, those allegations act only as a collateral means to collect money damages.” Therefore, courts would examine the pleadings to ascertain the purpose of the party seeking to maintain the lis pendens.

The legislature, aware of the conflict in the court decisions, noted that the definition of “real property claim” in the new law “neither includes nor excludes claims of constructive trust,” and left the law in this area for judicial development. Nevertheless, the legislature observed that if courts continued to allow the use of lis pendens for constructive trust claims, any prior history of abuse should be mitigated by the new provisions requiring proof by the claimant of probable validity of the claim and allowing the court to require a bond from the claimant.

In *BGJ Associates, LLC v. Superior Court*, the court upheld the expungement of a lis pendens, finding that a claim for constructive trust is not a real property claim under the revised lis pendens law. The plaintiffs in *BGJ* alleged that their business partners wrongfully acquired real property for themselves that the partnership had sought to acquire. The complaint contained 11 causes of action and sought damages and a constructive trust. The court recognized that, unlike prior cases involving constructive trust claims, the plaintiffs did not solely seek a constructive trust as collateral for money damages but also sought title to the property. The court even acknowledged that the plaintiffs had pleaded a claim that, if successful, would entitle them to the disputed real property. The plaintiffs argued that they were not required to elect between inconsistent remedies of money damages and title to the property and thus had pleaded a real property claim. However, out of concern for lis pendens abuse, the court held that the plaintiffs were not entitled to maintain a lis pendens when the pleadings sought monetary relief and the imposition of a constructive trust.

The holding in *BGJ* is questionable. First, the *BGJ* court did not explain why a claimant should be limited to seeking relief that exclusively affects title or possession to real property. The statute defining “real property claim” requires only that a claim affect title or possession of real property and does not provide that the resolution of title or pos-

**Courts need not—nor has the legislature empowered them to—act as gatekeeper on expungement motions because the legislature has put in place other safeguards to protect property owners.**
5. A real property claim gives constructive notice of the pendency of an action asserting a claim to real property.
   True.
   False.

2. The purpose of a lis pendens is to:
   A. Force a settlement.
   B. Notify the court that the action concerns real property.
   C. Notify prospective purchasers, encumbrancers, and transferees of litigation affecting title or possession of real property.
   D. Remedy damage to real property.

3. The practical effect of a lis pendens is a cloud on title making the affected property unmarketable.
   True.
   False.

4. In 1992, the California Legislature substantially revised the lis pendens law because:
   A. It was prone to abuse.
   B. It was too difficult to expunge a lis pendens.
   C. The existing law was due to expire.
   D. A and B.

5. A real property claim:
   A. Affects title to specific real property.
   B. Affects possession to specific real property.
   C. Neither includes or excludes claims of constructive trust.
   D. All of the above.

6. A court must expunge a lis pendens if:
   A. The moving party fails to prove the lack of probable validity of the real property claim.
   B. The action does not contain a real property claim.
   C. An undertaking would provide adequate relief even though the claimant establishes the probable validity of a real property claim.
   D. B and C.

7. A motion to expunge for want of a real property claim is treated like a demurrer.
   True.
   False.

8. The purpose of the party seeking to maintain a lis pendens is relevant to determining a real property claim.
   True.
   False.

9. Even if a claimant shows the probable validity of a real property claim, a court must expunge the lis pendens if an undertaking would provide adequate relief for the claimant.
   True.
   False.

10. Pursuant to Code of Civil Procedure Section 405.31, courts must expunge a lis pendens if the claimant also seeks monetary relief.
    True.
    False.

11. A fraudulent conveyance action is not a real property claim because it seeks to make real property available for the collection of a judgment.
    True.
    False.

12. In Kirkey v. Superior Court, the California Supreme Court ruled that a claim for a constructive trust on real property may never support a lis pendens.
    True.
    False.

13. One court summarized the law by noting, “If you properly plead a real property claim, you can file a notice of lis pendens; if you don’t, you can’t.”
    True.
    False.

14. The recordation of a lis pendens is absolutely privileged.
    True.
    False.

15. A property owner may sue for slander of title:
    A. Whenever a claimant records a lis pendens.
    B. After obtaining leave from court.
    C. After a lis pendens is expunged for lack of a property claim or probable validity.
    D. Under no circumstances.

16. A lis pendens is effective from the time it is:
    A. Filed with the court.
    B. Approved by the property owner.
    C. Recorded.
    D. Recorded and properly indexed by the recorder’s office.

17. Under the practical approach, the prevailing party on a motion to expunge is the party that did not realize its litigation objectives.
    True.
    False.

18. The practical approach to determining the prevailing party on motions to expunge is contrary to the legislative purpose behind the mandatory fee provision of Code of Civil Procedure Section 405.38.
    True.
    False.

19. If a claimant withdraws a lis pendens prior to a ruling on a motion to expunge, what must courts consider before awarding attorney’s fees?
    A. Whether the moving party would have prevailed on the motion.
    B. Whether the claimant withdrew the lis pendens for reasons unrelated to the merits of the motion.
    C. Whether it would be unjust to impose attorney’s fees.
    D. All of the above.
claim an ownership in the subject proprieties. The court of appeal thereafter denied the plaintiff's writ petition because the complaint did not contain a real property claim: “[T]he goal of the fraudulent conveyance action is to make the property available for the collection of a judgment, not to further a claim by [the plaintiff] to title of possession.”

The supreme court reversed the court of appeal's decision. The defendants contended that courts must ascertain the purpose of the party seeking to maintain a lis pendens, citing BGJ and similar decisions. But the supreme court rejected this argument, noting that neither Section 405.31 nor its legislative history directs the court to conduct this type of examination. Citing the legislative history, the supreme court noted that determining whether a claim is a real property claim involves a judicial examination solely of the pleadings. The court reasoned that a fraudulent conveyance action, if successful, might result in the voiding of a transfer of title to real property—and this necessarily affects title to or possession of real property. The plaintiff's fraudulent conveyance action thus fell within the “clear wording of the real property prong” of the lis pendens law.

The court refused to ignore the plain language of Section 405.31 even though it recognized that parties might abuse the availability of a lis pendens. However, the court noted that the new lis pendens law provides other grounds for expungement as well as protections to real property owners—such as the ability to expunge a lis pendens when the claimant cannot establish the probable validity of the real property claim.

Even after Kirkeby, courts continue to struggle with the definition of a real property claim. In Campbell II v. Superior Court, the plaintiff alleged that the defendant took advantage of the plaintiff's elderly and ill father, who gave the defendant $200,000 to remodel the defendant’s home. The complaint sought compensatory damages as well as the imposition of a constructive trust and equitable lien on the defendant’s home. The plaintiff recorded a lis pendens, which the trial court ordered expunged.

In upholding the expungement of the lis pendens, the Campbell II court concluded that the plaintiff's claims for an equitable lien and constructive trust were not real property claims sufficient to maintain a lis pendens. First observing that Kirkeby did not decide whether a real property claim includes a claim for an equitable lien or constructive trust, the court then employed the approach rejected by Kirkeby to determine whether the plaintiff's claims affected title to or possession of real property. Relying on the reasoning of cases rejected by Kirkeby, the court held that a party may not record a lis pendens "to freeze the real property as a res from which to satisfy a money judgment." The court also concluded that the plaintiff had not pleaded facts alleging title to the defendant's home—even though the complaint requested an equitable lien against the defendant's home, and the court acknowledged that the plaintiff is entitled to record an equitable lien “[w]hen a person wrongfully uses property of another in making improvements upon property already owned by the wrongdoer.”

As in BGJ, Campbell II did not limit its analysis to the pleadings and whether, if the plaintiff proved his allegations that the defendant obtained money from the plaintiff's father to improve the property through undue influence, the plaintiff would be entitled to an equitable lien or constructive trust. Instead, like BGJ, the Campbell II court examined the pleadings to ascertain the purpose behind the lis pendens and concluded that the plaintiff's claims were for the purposes of securing a money judgment.

However, the plaintiff's allegations were assumed to be true for the demurrer-like review under Section 405.31. If proven, the allegations would affect title to the property to the extent they supported an equitable lien against the defendant's property. Therefore, given the clear language of Section 405.31 and the Kirkeby decision, the Campbell II court should have reversed the expungement of the lis pendens. This result follows from the fact that the plaintiff's purpose in recording the lis pendens is legally irrelevant, as is whether the complaint seeks damages.

The test that a court applies when ruling on a motion to expunge pursuant to Section 405.31 is whether the pleading contains a real property claim. As one court noted, "[I]f you properly plead a real property claim, you can file a notice of lis pendens; if you don’t, you can’t." Courts need not—nor has the legislature empowered them to—act as gatekeeper on expungement motions because the legislature has put in place other safeguards to protect property owners.

Liability Risks

In addition to enacting new procedures making it easier for property owners to remove a lis pendens, the legislature amended Civil Code Section 47 in 1992 to add subdivision (b)(4), which limits the absolute privilege previously accorded to the recording of a lis pendens. Prior to this amendment, claimants and their attorneys had been immune from claims for slander of title. However, the court in Palmer v. Zakkama, relying on Section 47(b)(4), held that a lis pendens that is expunged either because the pleading does not allege a real property claim or because the claim does not have probable validity may support an action for slander of title. Thus, the Palmer court made it clear that under Section 47(b)(4), anyone who either 1) records a lis pendens that fails to allege a proper real property claim or 2) loses on the merits of a real property claim may be sued for slander of title.

In light of the legislature's overhaul of the lis pendens procedures to limit abuses, and the courts' continuing concern for this issue, the enactment of Civil Code Section 47(b)(4), together with Palmer, may be too much of a deterrent to real property claimants and their attorneys. Claimants with probable cause to record a lis pendens may choose not to do so or may be unable to retain an attorney willing to accept the risk of a slander of title lawsuit if the lis pendens is expunged.

It is unknown whether Palmer is having a chilling effect on claimants with real property claims. However, Palmer invites subsequent litigation every time a court expunges a lis pendens, regardless of the circumstances.

To avoid these consequences, the legislature should amend Civil Code Section 47(b)(4) to limit the privilege only to circumstances in which the claimant lacked probable cause or substantial justification to record a lis pendens.

In addition to the threat of claims for slander of title, attorneys who record a lis pendens also face the threat of malpractice claims after Dyer v. Martinez. In Dyer, which involved a real estate purchase agreement, the plaintiff buyer sued the sellers for specific performance. The plaintiff recorded a lis pendens the day before the sellers sold the property to other buyers. However, the recorder’s office did not index the lis pendens in the official land records until four days after the sale. The buyers did not discover the lis pendens through a title search because it was not indexed, and they did not have actual notice of it. The trial court granted the buyers' motion to expunge the lis pendens because it was ineffectual and thus did not provide constructive notice.

On appeal, the plaintiff observed that Section 405.24 makes a lis pendens effective “from the time of recording.” The plaintiff therefore argued that, despite recording laws to the contrary, the indexing of a lis pendens is not a prerequisite for constructive notice.

The Dyer court refused to read Section 405.24 literally and concluded that the legislature did not intend to change well-established law making the indexing of recorded documents a prerequisite for constructive notice. In support of this conclusion, the Dyer court noted that the buyers could not discover the lis pendens before it was indexed and thus did not receive constructive notice. The court reasoned that placing the risk of
loss due to a recorder’s delay or mistake in indexing a lis pendens on claimants provides an incentive for them to ensure prompt and accurate indexing. Indeed, placing the risk of loss on innocent purchasers does nothing to ensure the timely or proper indexing of a lis pendens. The court held that because the recorder’s office had not indexed the plaintiff’s lis pendens, the lis pendens could not be located by a title search and thus did not provide constructive notice—even though the plaintiff recorded it prior to the sale of the property.37

After Dyer, claimants filing a lis pendens and their attorneys must ensure that the recorder’s office promptly and accurately indexes the recorded lis pendens. Furthermore, to avoid possible malpractice claims, attorneys should also make every effort to identify and provide actual and verifiable notice to prospective buyers as well as escrow and title companies.

Aside from the potential exposure for slander of title, claimants are at risk for attorney’s fees if the court expunges their lis pendens.38 After Castro v. Superior Court,39 claimants cannot even avoid incurring any obligation for attorney’s fees by withdrawing a lis pendens while a motion to expunge is pending.

In Castro, the trial court denied the property owners’ first motion to expunge the lis pendens. The owners then brought a second motion to expunge. Before the hearing on the second motion, the claimants voluntarily withdrew the lis pendens because they were unable to complete meaningful discovery to oppose the second motion. The owners nevertheless sought attorney’s fees pursuant to Section 405.38 as the prevailing parties on the second motion. The trial court decided it could not find that the owners were the prevailing parties for purposes of Section 405.38 because the claimants withdrew the lis pendens prior to the hearing on the motion. However, the court of appeal disagreed with the trial court and held that the withdrawal of a lis pendens while a motion to expunge is pending does not preclude recovery of attorney’s fees to the moving party.40 In support of its holding, the Castro court recognized that the legislature, as part of its 1992 effort to curb lis pendens misuse, made an award of attorney’s fees mandatory unless the nonprevailing party acted with substantial justification or the awarding of fees would be unjust. However, Section 405.38—which provides for mandatory attorney’s fees—does not define “prevailing party.” Therefore, the Castro court adopted what it termed the “practical approach” to determine the prevailing party on a motion to expunge.

According to Castro, the prevailing party is the one that realized its litigation objectives.41 The court recognized that a party filing a motion to expunge a lis pendens achieves its objective if the other party withdraws the lis pendens while the motion is pending. However, the court held that a trial court must consider more than the mere withdrawal of a lis pendens to determine whether the moving party met its litigation objectives.

Notwithstanding the withdrawal of the lis pendens, the trial court must still determine whether the moving party would have prevailed on the motion. Even if the court decides it would have granted the motion, it must also determine whether the claimant withdrew the lis pendens for reasons unrelated to the merits of the motion—for example, a settlement—and whether in light of all the circumstances, it would be unjust to impose attorney’s fees. The moving party is not entitled to attorney’s fees under Section 405.38 until the court considers all of these factors.42 The Castro court reasoned that the practical approach is consistent with the legislative purpose behind the mandatory fee provision—to curb lis pendens abuse.43 Conversely, a rule that precludes attorney’s fees whenever a claimant withdraws a lis pendens before a ruling on a motion to expunge would condone lis pendens misuse and deprive a moving party likely to succeed of the opportunity to recover its attorney’s fees. Therefore, withdrawing a lis pendens before the court can decide its merits does not automatically absolve the claimant of responsibility for the moving party’s attorney’s fees.

Lis pendens law has continued to evolve since the legislature substantially revised it in 1992. However, despite the California Supreme Court’s recent decision in Kirkbye, courts still grapple with what is and is not a real property claim. Rather than following Kirkbye’s approach for determining a real property claim, many courts apparently continue to examine the claimant’s purpose in recording the lis pendens as well as the other relief sought in the complaint. Consequently, many courts continue to expunge a lis pendens based on claims such as those for constructive trusts and equitable liens, regardless of whether they affect title to real property.

The continuing expungement of proper real property claims notwithstanding Kirkbye poses a dilemma for attorneys: risk malpractice by not filing a lis pendens, or risk a lawsuit by the property owner for slander of title if the court expunges the lis pendens for lack of a real property claim. Attorneys should not have to second guess what a court will or will not consider to be a real property claim, especially after Kirkbye.

Additionally, courts no longer need to overprotect property owners by expunging a lis pendens based on a complaint that seeks damages and affects title to property. In these cases, the courts retain the ability to expunge the lis pendens if it lacks merit or if an undertaking will provide adequate relief. Moreover, claimants who record a lis pendens based on a claim that is without merit risk both imposition of attorney’s fees and potential liability for slander of title. Therefore, if a proven claim would affect title to real property, the court should not expunge the lis pendens regardless of the claimant’s purpose or desire to obtain other relief.

Clients and their counsel face many risks when recording a lis pendens. The greatest is the potential exposure for slander of title if the lis pendens is expunged. Because of the need to record a lis pendens quickly after filing a complaint to prevent a transfer of real property to a bona fide transferee or encumbrancer, attorneys have not conducted discovery and must rely on evidence provided by their clients or forfeit their clients’ interests to specific real property. To protect attorneys in these situations, legislative change is needed to remove the risk of slander of title when attorneys record a lis pendens with probable cause or substantial justification.

Finally, when attorneys record a lis pendens and accept the risk of slander of title, they must now ensure that the recorder’s office promptly and correctly indexes it. At a minimum, attorneys should search title records to verify that the lis pendens appears on title to the property. They also should make every effort to give actual notice to any known buyers or encumbrancers.

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3. Amalgamated Bank, 149 Cal. App. 4th at 1011 (“[T]he practical effect of filing a lis pendens is to make the affected property unmarketable as long as the lis pendens remains of record.”) See also Miller & Starr, supra note 1.
5. See Amalgamated Bank, 149 Cal. App. 4th at 1012 (“The financial pressure created by a recorded lis pendens provided the opportunity for abuse, permitting parties with meretricious cases to use it as a bullying tactic to extract unfair settlements.”).
7. Code Civ. Proc. §§405.31, 405.32. A motion to expunge may also be brought on grounds that 1) the recording, service, or filing requirements are improper (see Code Civ. Proc. §405.23), 2) “adequate relief can be secured to the claimant by the giving of an undertaking” (see Code Civ. Proc. §405.33), and 3) the claimant’s failure to file an undertaking ordered by the court as a condition to maintaining a lis pendens (see Code Civ. Proc. §405.34).
9. However, courts may consider evidence that may be judicially noticed on demurrer. See Kirkbye v. Superior Court, 33 Cal. 4th 642, 648 (2004).
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10 Code Civ. Proc. §405.33 (“For purposes only of determining under this section whether the giving of an undertaking will secure adequate relief to the claimant, the presumption of Section 3387 of the Civil Code that real property is unique shall not apply, except in the case of real property improved with a single-family dwelling which the claimant intends to occupy.”).

11 Code Civ. Proc. §405.4 (A real property claim also is one that would affect the use of an easement.).


15 Id. at 970-71.

16 Id. at 970.

17 Id. at 972.

18 Although the moving parties in BGJ did not seek to expunge the lis pendens for lack of probable validity of the real property claim, they could have done so even if the court denied their motion to expunge for lack of a real property claim. Castro v. Superior Court, 116 Cal. App. 4th 1010, 1014, n.9 (2004) (“Section 405.30 does not preclude a subsequent motion to expunge.”).


20 Id. at 650.

21 Id. at 647.

22 Id. at 649 (citing Hunting World, Inc. v. Superior Court, 22 Cal. App. 4th 67 (1994)).

23 Id. at 651 (“If this is problematic, it is up to the Legislature—and not this court—to change the law.”).


25 Id. at 908.

26 Id. at 921 (citing Restatement of Restitution §206).

27 Id. at 918.


30 According to Civil Code §47(b)(4), “A recorded lis pendens is not a privileged publication unless it identifies an action previously filed with a court of competent jurisdiction which affects the title or right of possession of real property, as authorized or required by law.” (Emphasis added.)

31 Albertson v. Raboff, 46 Cal. 2d 375, 380-81 (1956) (recordation of a lis pendens is absolutely privileged even if made with actual malice).


33 A lis pendens will not support an abuse of process claim. Woodcourt II Ltd. v. McDonald Co., 119 Cal. App. 3d 245, 250 (1981). However, it may support a claim for malicious prosecution. Albertson, 46 Cal. 2d at 381.

34 See William McGrane, The Increased Risk of Slander of Title, LOS ANGELES LAWYER, Jan. 2004, at 60.

35 Id. at 1242.

36 According to Code of Civil Procedure §405.38, “The court shall direct that the party prevailing on a motion to expunge be awarded the reasonable attorney’s fees and costs of making or opposing the motion unless the court finds that the other party acted with substantial justification or that other circumstances make the imposition of attorney’s fees and costs unjust.”


38 Id. at 1014.

39 Id. at 1019.

40 Id. at 1023.

41 Id. at 1024.

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Los Angeles Lawyer February 2008 33
The subprime lending crisis continues to expand, and foreclosures are rising at an alarming rate. RealtyTrac, Inc., recently reported that the number of foreclosure filings in the third quarter of 2007 nearly doubled from last year nationwide, and California cities dominate metropolitan foreclosure rates. As a result, attorneys in many practice areas can expect calls from existing and potential clients affected by a foreclosure. Attorneys may need to advise clients faced with a foreclosure notice or, even more dire, determine what relief is available for a client whose property has already been sold at a foreclosure sale. Knowledge of the basic requirements and timelines applicable to foreclosure sales and the narrow but increasingly relevant avenues available in California for setting aside foreclosure sales will be useful to legal practitioners in many diverse areas of practice.

In most cases, a property can be sold at foreclosure in a matter of months. When responding to a foreclosure, therefore, timing is critical. Before the foreclosure sale, the client still has hope of seeking injunctive relief to delay an improperly noticed foreclosure sale or one based on fraud. However, after the sale has been conducted, a client seeking to avoid foreclosure is usually out of options. If the foreclosure sale is final, and the client’s property is sold to a bona fide purchaser for value, the client will be unable to recover the property, even if the default and foreclosure sale were improperly noticed. Even if the purchaser is purported not to be bona fide, attacking a completed foreclosure sale is an extremely difficult process that may prove too costly for most clients.

Therefore, the first advice counsel should give to a client facing foreclosure is to act quickly during the time before a foreclosure sale to determine whether the foreclosing party has followed all statutorily required procedures. Failure to take timely action may...
permanently bar the client from seeking redress after the foreclosure sale—and may expose the attorney to a malpractice suit.

Since contesting a foreclosure is often a time-consuming and complicated process, the potential costs incurred may be prohibitive. Clients facing foreclosure are typically in difficult financial straits and may not be able to afford the fees of their attorneys, experts, and investigators over a long legal battle. Moreover, if the borrower loses the action and the loan documents contain a clause granting attorney’s fees to the prevailing party or a clause granting fees on collection, the borrower could also be required to pay the attorney’s fees of the foreclosing party. If this liability arises post-foreclosure, antideficiency statutes will not protect the borrower. Attorneys need to ask their clients—and themselves—whether fighting the foreclosure will ultimately do the client more harm than good, given the legal fees and costs involved.

One way to avoid the time and expense associated with the lender conducting a foreclosure, and the borrower challenging it, is to attempt a negotiated solution with the lender, such as a loan workout, a forbearance agreement, a deed in lieu of foreclosure, a consensual sale of the property, a refinancing of the property, or filing bankruptcy to invoke the automatic stay and delay the foreclosure. Attempts at a negotiated solution can and should be undertaken in addition to conducting the necessary investigations and diligence for challenging a sale. Counsel should be familiar with these approaches and be prepared to discuss them with the client.

If possible, the borrower should seek to cure the default. By statute, the trustee under a deed of trust securing a loan\(^5\) may cure a default and avoid a foreclosure sale by paying the defaulted balance due to the lender (but not the full accelerated balance) plus reasonable costs and expenses of enforcement.\(^6\) The borrower may reinstate the loan anytime up to five days prior to the foreclosure sale. This may be accomplished by a new recorded notice of sale or by postponement at a scheduled sale.\(^7\)

The foreclosing beneficiary has the duty to provide, upon demand, a payoff demand statement clearly setting forth the amount that must be paid to reinstate the loan.\(^8\) If the foreclosing beneficiary fails to provide this statement, the trustee can pay the amount the trustee reasonably thinks is due and seek an injunction of the foreclosure sale, in addition to recovering attorney’s fees and costs.\(^9\) If the borrower does not seek an injunction and the property is sold at foreclosure to a bona fide purchaser, the borrower’s remedies become almost nonexistent.

Although reinstatement usually occurs when the borrower tenders the necessary payment, the borrower and the lender can also make an agreement that will result in reinstatement of the loan.\(^10\) In Bank of America, N.A. v. La Jolla Group II, the court determined that a property sale at foreclosure could be set aside upon proof that the borrower entered into an agreement with the lender to cure the default. The court held that the trustor’s deed delivered to the purchaser “was properly cancelled as void because the sale was conducted in violation of an agreement between the trustor and the beneficiary to cure the default and reinstate the loan—i.e., the beneficiary had no right to exercise the power of sale.”\(^11\)

Borrowers also have the right to redeem the property by paying the full amount owed on the mortgage to the foreclosing creditor any time before the sale.\(^12\) Reinstatement requires that a borrower cure the default and resume loan payments; redemption, on the other hand, requires full payment of the outstanding balance of the loan plus any interest and penalties.

If the borrower disputes the amount demanded by the foreclosing lender, the borrower may seek an injunction until the court determines the amount the borrower needs to pay to reinstate the loan, or the borrower may pay the disputed amount and sue the lender to recover the excess.\(^13\) However, counsel should consider the costs of seeking injunctive relief or suing for a disputed excess, as the legal fees may exceed any disputed amount.

### Procedural Rules

Strict requirements govern the notice and posting procedures prior to a foreclosure sale.\(^14\) Only after all the notice and posting procedures are strictly followed may the foreclosure sale be validly conducted. Therefore, counsel should work with the client to research all published and posted notices, and conduct of a foreclosure sale. However, if there is no objection to the defective notice and the property is sold at foreclosure to a bona fide purchaser for value, a conclusive presumption of the validity of the sale applies and is extremely difficult to overcome.

Counsel should also immediately ascertain whether injunctive relief may be available to forestall the foreclosure process for reasons other than notice and conduct of the sale process. Relief can be obtained, for example, on the basis that no default actually exists,\(^15\) if the underlying trust deed is fraudulent or otherwise invalid,\(^16\) or because the lender charged unlawful penalties.\(^17\) In the absence of these avenues, client and counsel may return to an examination of timeliness of notice.

An attorney with a client facing foreclosure should carefully examine the timeliness requirements of Civil Code Section 2924 and its following sections. When a borrower defaults on payment of a deed of trust, the lender who chooses to foreclose nonjudicially must start by recording a notice of default, sometimes referred to as an NOD, in the office of the county recorder where the property subject to the lien is located.\(^18\) A notice of default recorded prematurely—that is, before the debtor is actually in default—has no legal effect.\(^19\) Additionally, if there is no default and the property is subsequently sold in foreclosure, the borrower can set the sale aside based on the fact that there was no default from the outset.\(^20\) The notice of default is the trigger to the foreclosure process, as the foreclosure sale cannot be noticed until three months after a valid notice of default has been recorded.\(^21\)

The notice of default must include 1) a statement identifying the mortgage or deed of trust being foreclosed by stating the name or names of the trustor or trustees (borrowers) and giving the book and page, or instrument number, in which the mortgage or deed of trust is recorded or a description of the mortgaged or trust property,\(^22\) 2) a statement that a default has occurred in the obligation for which the lien is security,\(^23\) 3) a statement describing each default actually known to the foreclosure party and of its election to sell the property to satisfy the obligation secured by the lien,\(^24\) and 4) if the default is curable under Section 2924c of the Civil Code, the statement specified in that section that identifies the borrower’s rights to cure the default and reinstate the loan.\(^25\)

If any of the above requirements for the notice of default and allowance of reinstatement or redemption have not been met, counsel can seek injunctive relief on the basis of noncompliance with the statute, and the foreclosure process can be delayed until proper notice is given.\(^26\) In addition, if a borrower receives (or lender sends) notice of a foreclosure sale less than three months after the notice of default, counsel can seek injunctive relief.\(^27\)

The foreclosure party or other person authorized to record the notice of default or the notice of sale\(^28\) must also provide other statutorily specified notices (by registered or certified mail with postage prepaid) to various parties to the underlying transactions (including junior lienholders) and third parties who have for any reason caused their
names to be recorded either in the deed of trust for notice purposes or by recording a separate request for notice in the public records in which the deed of trust was recorded. Deadlines for such notice vary according to the party notified. Counsel should check to ensure that the foreclosing party has fully complied with the statutory notice requirements.

Simultaneously with the registered or certified mail notices, the trustee or mortgagee (lender) must mail an additional copy by first class mail to the same address and execute and return an affidavit that notice was mailed. Note that the statute does not require that the first class letter be actually received. An affidavit of the mailer establishes conclusive presumption of mailing, absent some proof of fraud. After at least three months have passed after the date the notice of default was properly filed, the mortgagee desiring to continue the foreclosure process must give notice, including the specific time and place, of the foreclosure sale. Lenders may notice a foreclosure sale years after the default date—the court in Ung v. Kohler held that foreclosure was not barred even though the trustee waited over four years after the maturity date of the obligation had passed. 29

The notice of sale must include: 1) the trustee’s name, street address in California (which may reflect an agent of the trustee), and California telephone number, 2) the time of sale and the street address where the sale will be held (often on the courthouse steps), 3) the name of the original trustor, 4) the verbatim text of the lengthy statement in Civil Code Section 2924(c)(3), 5) a description of the property, including its street address and a county assessor’s parcel number, 6) a statement of the total amount of the unpaid balance of the obligation secured by the property to be sold, and 7) a reasonable, good faith estimate of costs, expenses, and advances at the time of the initial publication of the notice of sale. 30 If the sale of the property involves real property and personal property or fixtures, the notice of sale must, in addition to other requirements of the Civil Code, contain a description of the personal property or fixtures to be sold. 31 Civil Code Section 2924f delineates the requirements for noticing, posting, publication, and recording of a foreclosure sale notice. The notice of sale must be recorded with the recorder of the county in which the property is located at least 14 days prior to the date of sale. 32

In addition to mailing, notice of the sale must be posted in writing at least 20 days before the date of sale in a conspicuous place on the property to be sold, and in either a public place in the city where the property is to be sold (if the property is to be sold in a city), or a public place in the judicial district.

In which the property is to be sold. Notice of the sale must also be published once a week for three consecutive calendar weeks in a newspaper of general circulation published in the city in which the property is located. Counsel for a client facing foreclosure should investigate whether the mortgagee or trustee has completed these tasks and seek injunctive relief if not.

Civil Code Section 2924 sets forth the procedures governing the conduct of a foreclosure sale, including who can bid, where the sale must be held, bids prior to sale, and other requirements. It is illegal for anyone to attempt to improperly influence a foreclosure sale, including offering to accept or actually accepting any consideration of any type not to bid, or fixing or restraining bidding in any manner. 33 In cases in which the sale has been improperly influenced, counsel can seek to have the sale set aside. Aside from serving as a basis for setting aside a sale, improperly influencing a foreclosure sale carries penalties of up to $10,000 and imprisonment, in addition to civil remedies. 34 There are many ways a lender can be found to have improperly influenced a bid at foreclosure, even if inadvertently, so counsel should review the facts leading up to a sale, including communications the lender may have had with the borrower and with third parties in the days prior to a sale, to determine if any improper activities have occurred.

**Challenging a Sale**

Setting aside a completed foreclosure sale is extremely difficult. Public policy strongly favors the finality of foreclosure sales. 35 Once a deed reciting that all legal requirements have been satisfied is delivered to a buyer at a foreclosure sale, there is a presumption of the validity of the sale. In the case of a BFP, 36 this presumption is conclusive. 37 Additionally, an action to set aside a foreclosure sale is an action in equity, ordinarily with no right to a jury trial. 38 Nevertheless, if clients do not contact a lawyer until after the foreclosure sale has been completed, or if the attorney has exhausted all avenues to delay the sale, counsel and the client may consider undertaking the expense and effort to have the sale set aside.

A borrower can seek to set aside a sale on the basis that the underlying security instrument pursuant to which the sale is being noticed is itself invalid 39 or that there was collusion or fraud in the bidding process: 40 “The law has long provided that if a non-judicial foreclosure sale has been unfairly or unlawfully conducted, or is tainted by fraud, the trial court has the power to set it aside.” 41 Such an order is proper if “there has been such a mistake that to allow [the foreclosure] to stand would be inequitable….” Sham bidding and the restriction of competition are condemned, and inadequacy of price coupled with other circumstances of fraud may constitute grounds for setting aside the sale. 42

If the purchaser is not a BFP, it may be possible to set aside the foreclosure sale on the basis of fraud or procedural irregularity in the notice or conduct of the sale. The first question to ask in determining BFP status is whether the buyer is an individual or a business. If the buyer is an individual, evidence of that individual’s fraud may be difficult to obtain. In the case of a company, however, an important distinction exists if that company is in the business of purchasing properties at foreclosure sales. The court in 6 Angels, Inc.
v. Stuart-Weight Mortgage, Inc., stated that the fact that the buyer was a company in the business of purchasing properties at foreclosure sales was evidence that the buyer was not a BFP.41 In Estate of Yates, the court dealt with an irregular foreclosure and articulated several factors for determining whether a buyer is a BFP. The court concluded that the buyer in that case was not a BFP based on two primary factors: First, the buyer was “in the business of purchasing property at a trustee’s sale and frequently attends foreclosure sales,” and second, the buyer had prior knowledge that the $12,000 eventually offered for the property was substantially below the $120,000 fair market value of the property.42 Melendez v. D & I Investment, Inc., expanded on the decisions in 6 Angels and Yeats, emphasizing that while the fact that a company in the business of purchasing properties at foreclosure sales is evidence that it is not a bona fide purchaser for value, this fact does not, by itself, amount to conclusive evidence that the buyer is not a BFP.43 The court stated: “[T]he proper standard to determine whether a buyer at a foreclosure sale is a BFP is whether the buyer (1) purchased the property for value, and (2) had no knowledge or notice of the asserted rights of another.”44 In a note, the court also observed: “[I]n evaluating whether a buyer at a trustee’s sale is a BFP, the buyer’s foreclosure sale experience may be considered in making the factual determination of whether he or she had knowledge or notice of the conflicting claim.”45

It can be established that the buyer is not a BFP, the validity of the foreclosure sale may be attacked on the grounds of procedural irregularities in the foreclosure. If the discrepancy between sale price and fair market value is great, even a slight irregularity in the notice or conduct of a foreclosure sale can be enough to set aside the sale as against a non-BFP.

Where the price obtained is greatly disproportionate to actual value, relief is authorized on very slight evidence of unfairness or irregularity involving any type of dishonesty, deception, or oppression operating to the prejudice of the judgment debtor…regardless of whether it amounts to legal fraud… Where it appears that the gross inadequacy of price has resulted from the unfairness of the purchaser or the fact that he has taken undue advantage, the purchaser may be deemed guilty of fraud warranting the interposition of equity in favor of an owner who is without fault.46

However, gross disparity in purchase price alone, even if coupled with the buyer’s non-BFP status, is not adequate grounds to attack the validity of the sale. There must be a procedural irregularity or fraud (such as collusive bidding) in order to set aside the sale.47 Also, in cases of illegal and fraudulent foreclosure sales, the borrower may be able to seek damages for interference with contractual rights.48

It is important to note that just alleging, or even proving, any irregularity in the foreclosure process—no matter how small—does not assure a successful result in situations in which there are no other egregious facts. Any irregularity in which the borrower fails to show injury (mere sale of the property may not be sufficient injury if the borrower was otherwise truly in default and would have lost the property anyway once the defect was corrected)49 is at risk of leading to an unsuccessful challenge. As is the case generally with minor or technical defects in legal matters, claims opposing foreclosure that are based on minor problems do not usually find much sympathy with courts, and bringing such a claim may result in the client paying nonrecoverable legal fees, only worsening the client’s position.

A significant hurdle for many borrowers who might otherwise seek to attack a completed foreclosure sale based on fraud or irregularity is that the borrower in such a case must tender the outstanding indebtedness in order to cancel a voidable sale under a deed of trust.50 If a client does not have sufficient funds to tender the outstanding indebtedness, counsel can use negotiations to try leveraging any amount that might be recoverable from a lender to offset the required tender.

Deficiency Issues
A client facing foreclosure may not only lose property but also face a deficiency judgment. Counsel must ascertain whether antideficiency statutes will protect the client from having to pay this difference between the amount bid at the foreclosure sale (or the fair value of the property if the bid is lower than fair value) and the amount of the debt. Antideficiency statutes are a series of laws, two of which are of primary importance to clients facing foreclosure. One protects 1) those who borrow directly from the seller of a property and give the seller a lien and 2) those who borrow the purchase price on an owner-occupied single family property (a property improved with one to four residential units) and who have offered the property as security for the purchase money loan.51 This law provides that the seller as lender or the third-party purchase money lender may not pursue the borrower individually for any deficiency under any circumstance (including after a judicial sale). The former residential property owner may have lost the property but can at least walk away from the foreclosure sale without further monetary liability in most cases.52 The second important antideficiency law protects all borrowers from a deficiency following a nonjudicial foreclosure sale when a deficiency judgment would have been possible if the foreclosure had been done judicially.53

In Brown v. Jensen, the California Supreme Court extended the purchase money antideficiency protection by holding that purchase money junior liensholders could not bring actions on their notes after the security had become valueless because of a sale by the holder of the purchase money first deed of trust. Normally, a junior lienholder whose security is lost in the foreclosure sale by a senior lienholder (that is, a sold-out junior lienholder) still has the right to sue on the note to recover its debt. However, the Brown court stated:

The broad protection provision (Code Civ. Proc., § 580b) for purchase money trust deeds stands on a reasonable footing. A purchase money trust deed is not like an ordinary trust deed and note…. With purchase money trust deeds… the character of the transaction must necessarily be determined at the time the trust deed is executed. Its nature is then fixed for all time and as so fixed no deficiency judgment may be obtained regardless of whether the security later becomes valueless.54

The above scenario applies only when the junior lien was part of the original purchase transaction. Antideficiency protection applies to liens undertaken as part of the purchase transaction, even when more than one lien exists, as long as those liens were part of the purchase money mortgage.55 However, if the sold-out junior lienholder’s trust deed is not a purchase money mortgage, the lienholder may be able to recover the deficiency against the borrower directly.56 Therefore, whether the purchase money antideficiency statute applies to bar lienholders from collecting against the borrower depends on the individual facts of each case.

As the housing and credit slump continues, an increasing number of borrowers face foreclosure of their properties. Helping a client navigate through the maze of foreclosure deadlines and rules is a daunting task. Once a foreclosure sale has been completed, it becomes even more difficult to gain any sort of victory for the client. Because attacking a completed foreclosure sale is only available on extremely limited grounds, counsel should work hard at the beginning of the foreclosure process to avoid the undesirable (and many times unavailable) last resort of attacking a completed sale. The borrower’s likely financial difficulties—or presumably the borrower would not be in foreclosure—will be a com-
providing relief for the foreclosure crisis. However, the proposed legislation does not offer much help to homeowners who are already in default, and the effectiveness of the proposed legislation is yet to be determined.

2 The vast majority of foreclosures in California are non-judicial. Judicial foreclosures are also possible here, but since they occur in a courtroom, borrowers receive the protection of the due process of litigation. Judicial foreclosures are authorized by Code of Civil Procedure §725a.

3 As foreclosures rise, so have fraudulent foreclosure prevention schemes, with elderly homeowners among the targets. See, e.g., http://www.mortgagefraudblog.com. A foreclosure may be subject to injunctive relief if procured by fraud.

4 See infra notes 23 and 30 and accompanying text.

5 The code sections regarding foreclosure refer to borrowers as trustees, mortgagors, and sometimes debtors, and lenders as beneficiaries or mortgagees. The trustee under the deed of trust is often a title company or professional foreclosure service provider.

6 CIV. CODE §2924(a)(1) and (e).

7 CIV. CODE §2924(c).

8 CIV. CODE §2924(c)(1).

9 MILLER & STARR, CALIFORNIA REAL ESTATE §10:1

10 It is prudent to make sure any agreement to cure is in writing to avoid potential issues with the statute of frauds.

11 The Rutte Group, California Practice Guide: Real Property Transactions ch. 64, §6:368.8 (Circular Bank of America, N.A. v. La Jolla Group II, 129 Cal. App. 4th 706, 830 (2005)).

12 CIV. CODE §52903 et seq.


14 CIV. CODE §52924 et seq.


18 CIV. CODE §2924(a)(1).


21 CIV. CODE §2924b.

22 CIV. CODE §2924(a)(1)(A).

23 CIV. CODE §2924(a)(1)(B).

24 CIV. CODE §2924(a)(1)(C).

25 CIV. CODE §2924(a)(1)(D). See also CIV. CODE §2924c.


27 CIV. CODE §2924(a)(2); CIV. CODE §2924g.

28 Notices are often recorded and served by foreclosure service firms hired by the lender. This does not affect the validity of the notices as long as the statutory requirements are met.


30 CIV. CODE §2924(b)(1). An inaccurate statement of the amount does not affect the validity of any sale to a bona fide purchaser for value, nor does the failure to
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post the notice of sale on a door. Id.

34. Id.
41. Id. at 1096 (citing Bank of America Nat’l Trust & Sav. Ass’n v. Reidy, 15 Cal. 2d 243, 248 (1940)).
43. 6 Angels, Inc., 85 Cal. App. 4th at 1286.
46. Id. at 1233 (italics in original).
47. Id. at n.23.
48. 30 CALIFORNIA JURISPRUDENCE 3D, Enforcement of Judgments §183 (citing Darden v. Reese, 88 Cal. App. 2d 904 (1948)).
53. CODE CIV. PROC. §380b.
54. Id. Liability can accrue postforeclosure in certain circumstances when borrowers commit fraud or misrepresentation, environmentally contaminate a property, or commit bad faith waste (intentional injury to one’s property). (2001).
55. CODE CIV. PROC. §580d.
57. 39 Stirton v. Pastor, 177 Cal. App. 2d 24 (1960). The court went on to recognize an exception to the rule, stating that §580b applies automatically only to a “standard” purchase money transaction, which it described as one in which the purchaser is going to continue the same or similar use of the property. Id. at 609-10. The court concluded that §580b does not automatically apply when the vendor agrees to subordinate its lien to the purchaser’s construction loan because the purchaser does not intend to continue with the same use of the property. Id. at 614.
58. 31 CIV. CO §56 Brown v. Jensen, 41 Cal. 2d 193, 197 (1953) (en banc).
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Does a Lawyer or Law Firm Have an Ethical Conflict of Interest When a Fee Dispute Arises with a Client during the Representation?

**SUMMARY:** Fee disputes between attorneys and clients are a fact of life. In Committee Opinion No. 476, the committee opined that it is improper for an attorney to sue a client for unpaid fees while remaining counsel of record for the client. This opinion addresses whether a lawyer or law firm has an ethical conflict of interest in continuing to represent a client after a fee dispute arises during the course of the representation. The committee concludes: 1) a fee dispute does not require a lawyer or law firm to seek to withdraw, 2) a fee dispute, by itself, does not create an ethical conflict of interest, and 3) a fee dispute, where the lawyer does not have any lien rights, is not an adverse pecuniary interest in a client’s property.


**Facts and Issues Presented**

Client retained law firm to defend it in connection with an action filed in state court (the litigation). They entered into a standard written retainer agreement, calling for law firm to provide legal services on an hourly basis. The written retainer agreement informs client of its right to discharge law firm at any time. The written retainer agreement does not give law firm a lien on, or any other security interest in, any of client’s property.

During the litigation, disputes arose between client and law firm over law firm’s billings. Client, through its general counsel, contends law firm’s bills are too high and refuses to pay the bills. At no time during the representation were claims made by the client regarding the quality of legal services provided.

Law firm does not represent client in any other matter.

**Issues**

Can law firm continue to represent client in the litigation after the fee dispute arises? Is a fee dispute during legal representation an ethical conflict of interest? Is a lawyer’s fee claim against a client an adverse pecuniary interest? Is it not an ethical conflict of interest for law firm to continue with the representation in light of fee dispute.

**Introduction**

None of the California Rules of Professional Conduct specifically addresses whether a lawyer or law firm has an ethical conflict of interest when a dispute arises with the client over the attorney’s compensation. Instead, the rules address specific issues regarding the attorney-client relationship, some of which may have a bearing on the attorney’s compensation, such as Rule 3-300’s requirement that an attorney not obtain an “interest adverse to a client” unless certain criteria are satisfied (discussed in Section D below). Another example is Rule 3-310(b)(4), which provides that a lawyer may have an

Citations in Los Angeles County Bar Association Ethics Opinions have been edited to conform to Los Angeles Lawyer style. The unedited original can be found online at www.lacba.org/ethicsopinions.
ethical conflict of interest where the lawyer has a “financial...interest in the subject matter of the representation.” However, that rule, by its plain terms, does not apply to the facts presented in this opinion because law firm does not have any financial interest in the litigation.

None of the specific prohibitions in the rules regarding an attorney’s compensation agreement with a client provide that in the event of a dispute with the client over the attorney’s compensation, the attorney has an ethical conflict of interest. Nor does case law hold that a fee dispute creates an ethical conflict of interest.

In reaching this conclusion, it is important to keep two points in mind. First, this opinion only addresses ethical conflicts of interest under the Rules of Professional Conduct. Although law firm and client may have a “conflict” in the lay sense of that phrase, such “conflicts” do not raise ethical issues under the rules, unless they escalate to a level where one of the other ethical rules becomes an issue. Thus, the committee concludes that the rules do not compel law firm to take any affirmative steps merely because of the fee dispute. As one court has noted, “[T]he tension between lawyer and client about fees always exists...” In reaching this conclusion, the committee notes that although a lawyer or law firm to seek to withdraw as counsel of record, it must continue to “perform legal services with competence.”

Rule 3-700 Permits the Law Firm to Remain Counsel of Record during the Litigation, Notwithstanding a Fee Dispute

Once the fee dispute arises, the fee dispute by itself does not require law firm to seek to withdraw as counsel of record in the litigation. Withdrawal is governed by Rule 3-700, which provides that withdrawal is mandatory in some instances (subparagraph (B)) and permissible in other instances (subparagraph (C)). Rule 3-700(C)(1)(d) provides that withdrawal may be permissible in the event the client breaches an agreement or obligation to an attorney regarding fees. Therefore, when a fee dispute arises, withdrawal can be permissible, not mandatory, although a lawyer may not abandon a client or withdraw “at a critical point and thereby prejudic[e] the client’s case.”

The implication in making withdrawal permissible, rather than mandatory, is that an attorney may continue to represent a client notwithstanding the existence of a fee dispute and, hence, no ethical conflict of interest exists under the rules. Therefore, by making withdrawal permissible when a fee dispute arises, Rule 3-700 effectively permits an attorney or law firm to make a “business judgment” about whether to remain counsel of record and continue representation of the client or to seek to withdraw. Inherent in such a decision is the lawyer’s and/or law firm’s pecuniary and self-interest.

The committee’s conclusion is also drawn from other factors. Generally, the negotiation of fees, including retainee agreements, between an attorney and a client is an arm’s-length transaction.\(^4\) While there is a statutory presumption that a transaction between an attorney and a client entered into during an attorney-client relationship is presumed to be a violation of the trustee’s fiduciary duties,\(^7\) that statutory presumption does not, by its plain terms, apply to attorney-client fee agreements.\(^4\) Therefore, attorneys are generally permitted to negotiate their fees with their clients on an arm’s-length basis, subject to the general rule that a lawyer may not “enter into an agreement for, charge, or collect an illegal or unconscionable fee.”\(^9\) However, the committee’s conclusion that law firm is not required to file a motion to withdraw is not the end of the matter. So long as law firm remains counsel of record, it must not “fail to perform legal services with competence,” under Rule 3-110(A), or otherwise breach its ethical duties. The fee dispute does not relieve law firm of those obligations so long as it remains counsel of record.\(^10\) If the fee dispute reaches a point where law firm believes that it can no longer adequately represent client’s interests in the litigation, then it should file a motion to withdraw.\(^11\) Moreover, if the fee dispute becomes sufficiently contentious or adversarial, the attorney may seek to withdraw not because of the mere existence of the fee dispute but because the nature of the consequences of the fee dispute are such that it “is unreasonably difficult...to carry out employment effectively,” under Rule 3-700(C)(1)(d). Such issues are not raised by the facts of this opinion.

Accordingly, the committee believes that a fee dispute, by itself, does not require a lawyer or law firm to seek to withdraw as counsel of record.\(^12\) A Fee Dispute, by Itself, Does Not Create an Ethical Conflict of Interest within the Scope of Rule 3-310

The general definition of a conflict of interest is “when in behalf of one client, it is [the lawyer’s] duty to contend for that which another client requires him to oppose.”\(^13\) Conflicts of interest are usually governed by Rule 3-310. Rule 3-310, however, generally involves “conflicts of interest” that arise by virtue of the attorney’s relationship among various clients.\(^14\) Nothing in Rule 3-310 addresses fee disputes between an attorney and a client and no case has ever held that a fee dispute, by itself, constitutes a conflict of interest under Rule 3-310.

As noted, Rule 3-310(b)(4) does not apply because law firm does not have any financial interest in the litigation. Moreover, the California Supreme Court has held that Rule 3-310(b)(4) “addresses not the existence of general antagonism between lawyer and client, but tangible conflicts between the lawyer’s and client’s interests in the subject matter of the representation.”\(^15\) The committee believes that the fee dispute between law firm and client falls within the rubric of “general antagonism between lawyer and client” which does not implicate Rule 3-310.\(^16\)

The committee’s opinion is supported by other considerations. Attorneys by their very nature act in a dual role: as an advocate for their client and as a business for themselves.\(^17\) As noted, the potential for a “conflict” (in the lay, not ethical, sense) between the lawyer's financial interests and those of the client exists in every attorney-client relationship, whether on a contingency basis or for an hourly fee, just as they do in any other commercial transaction.\(^18\) Fee disputes arise in a variety of contexts. A client may simply call a lawyer and ask for a $500 reduction in an invoice for no reason at all. Or a client may be experiencing financial difficulties and is asking for a reduction in fees for that reason. Once a dispute is created, the amount is irrelevant. In the experience of the members of the committee, the vast majority of “fee disputes” are resolved amicably between the client and the lawyer/law firm with little if any acrimony. Some do not resolve amicably and the client has legal options available. However, the committee does not believe that a fee dispute, by itself, creates a conflict of interest under Rule 3-310.

Therefore, the committee concludes that a fee dispute, by itself, is not an ethical conflict of interest under Rule 3-310. This conclusion is consistent with Rule 3-700 because, as discussed above, that rule permits a lawyer to remain as counsel of record, notwithstanding a fee dispute. Because the committee concludes that Rule 3-310 is not implicated, it follows that law firm does not have to make any disclosures; obtain client’s written, informed consent to continue with the representation; or otherwise comply with any of the procedural requirements in Rule 3-310(C).\(^19\)

A Fee Dispute Is Not an Adverse Pecuniary Interest to a Client within the Scope of Rule 3-300

Rule 3-300 provides that an attorney shall not “enter into a business transaction with a client, or knowingly acquire an ownership interest, possessory or other pecuniary interest adverse to a client,” unless the criteria of paragraphs (A)-(C) of the rule are satisfied. The Discussion Note to Rule 3-300 clearly states that Rule 3-300 is not intended to
apply to “the agreement by which the member is retained by the client, unless the agreement confers on the member an ownership, possessory, security or other pecuniary interest adverse to the client.”

In Fletcher v. Davis, 33 Cal. 4th 61, 67-69 (2004), the California Supreme Court held that a charging lien contained in an attorney’s retainer agreement was an adverse pecuniary interest within the meaning of Rule 3-300. The court based its ruling upon the fact that a charging lien could significantly impair the client’s interest by delaying payment of the recovery or settlement proceeds until any disputes over the lien can be resolved. For example, when there is a dispute over the existence or amount of an attorney’s charging lien, the attorney can prevent the judgment debtor or the settling party from receiving the recovery to the client until the dispute is resolved.

(Id. at 68-69.) The court, however, contrasted a charging lien with an unsecured promissory note, which gives an attorney only a right to proceed against the client’s assets in a contested judicial proceeding at which the client may dispute the indebtedness. The note allows the attorney to obtain a judgment, and to seek to enforce the judgment against the client’s assets, if any. It does not give the attorney a present interest in the client’s property which the attorney can summarily realize.

(Id. at 68, italics added.)

Here, law firm’s retainer agreement does not give law firm any lien rights. Instead, law firm’s billing statements sent to client are simply a demand for payment. Like an unsecured promissory note, the billing statements do “not give the attorney a present interest in the client’s property which the attorney can summarily realize.” Law firm would have to bring a judicial action against client for unpaid fees, which client could contest. Law firm would have to reduce its claim to fees to a judgment after an adversarial proceeding. Thus, law firm’s unsecured demand for payment of fees is similar to an unsecured promissory note, which Fletcher and Hawk held did not implicate Rule 3-300.

As noted, in Committee Opinion No. 476, the committee opined that it is improper for an attorney to sue a client for unpaid fees while remaining counsel of record for the client. Opinion No. 476 also noted that in Opinion No. 212, the committee opined that an attorney should withdraw from all matters in which representation is being provided to the client prior to commencing litigation for costs or fees. The committee reaffirms these opinions and believes that is where the “line should be drawn” in the context of fee disputes between attorneys and clients, i.e., law firm cannot sue client for unpaid fees during the representation.

Because law firm’s demand for payment cannot be reduced to a judgment or lien without first filing a judicial action, it follows that the fee dispute itself is not obtaining an adverse pecuniary interest to client within Rule 3-300 and does not require compliance with the requirements of that rule.

This opinion is advisory only. The committee acts on specific questions submitted ex parte, and its opinion is based on the facts set forth in the inquiry submitted.

1 Hereafter, any reference to a “rule” or “rules” is to the California Rules of Professional Conduct, unless otherwise indicated.
3 Rule 3-110(A) reads in relevant part: “A member shall not intentionally, recklessly, or repeatedly fail to perform legal services with competence.”
4 See Pineda v. State Bar, 49 Cal. 3d 753, 758-59 (1989).
create lien rights, and an attorney must send a notice of lien prior to suing a client. The reader is reminded that prior to suing a client, the lawyer or law firm rendering legal services below the standard of care. This opinion does not address standard of care issues, which are outside the jurisdiction of this committee.

11 See Manfredi & Levine v. Superior Court, 66 Cal. App. 4th 1128, 1135 (1998) (“[U]npaid fees to counsel” may constitute grounds for a motion to withdraw; decision discusses other situations where an attorney may seek withdrawal.)

12 A fee dispute may also form part of the basis for an attorney seeking mandatory withdrawal under Rule 3-700(B), but the facts of this opinion do not implicate such issues.


14 See CAL. RULES OF PROF’L CONDUCT R. 3-310(C).

15 Santa Clara County Counsel Attys. Ass’n v. Woodside, 7 Cal. 4th 525, 547 (1994).

16 Id.; see also Barnard, 109 Cal. App. 4th at 1459 (rejecting contention that a fee dispute between a law firm and client created a conflict of interest, citing Santa Clara County Counsel Attys. Ass’n, 7 Cal. 4th at 547).

17 “The lawyer occupies an anomalous position. He practices a profession but in doing so he carries on a business; he is an officer of the court and as such he is the agent of a citizen in matters of dispute between citizens or between the citizen and the state; and at the same time and in all things he must pursue the course which is consistent with recognized professional conduct.” Floro v. Lawton, 187 Cal. App. 2d 657, 673 (1960) (italics added).


19 It is difficult to see what practical effect requiring law firm to obtain written, informed consent would have, or how client is prejudiced by the lack thereof. Once the fee dispute arose, client is undoubtedly aware of the fee dispute, has an in-house general counsel representing its interests, was informed of the retainee agreement of its right to discharge law firm, and impliedly consents to the representation continuing. Cf. In re Friedman, 100 Cal. App. 4th 65, 71 (2002); Ramirez v. Studevant, 23 Cal. App. 4th 904, 918 (1994). In addition, if obtaining written, informed consent were mandated, if the client withheld such consent, the lawyer would then be forced to seek to withdraw, contrary to Rule 3-700, which makes withdrawal permissible rather than mandatory.


21 Hawk v. State Bar, 45 Cal. 3d 589, 600-01 (1988).

22 Even then, a judgment under California law does not create lien rights. Aldasoro v. Kennerson, 915 F. Supp. 181, 191 (S.D. Cal. 1995) (“A judgment does not automatically constitute a lien on anything in California, absent further actions by the judgment creditor.”).

23 Although outside the scope of this opinion, the reader is reminded that prior to suing a client for fees, an attorney must send a notice of right to arbitrate under California Business and Professions Code §§6021 et seq.
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<td>White, Zuckerman, Warsavsky, Luna, Wolf &amp; Hunt</td>
<td>Tel. 818-981-4266 <a href="http://www.wwllw.com">www.wwllw.com</a></td>
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<td>Witkin &amp; Eisinger, LLC</td>
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<td>WolfeSdorf Immigration Law Group</td>
<td>Tel. 310-570-4048 <a href="http://www.wolfsdorf.com">www.wolfsdorf.com</a></td>
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ON TUESDAY, FEBRUARY 12, Trial Advocacy and the Litigation Section will present a courtroom skills workshop, providing instruction for civil and criminal cases. The first part of the program consists of lectures and demonstrations covering how to call and excuse witnesses, mark exhibits, lay evidentiary foundations, make and respond to evidentiary objections, use demonstrative evidence, impeach witnesses, and move exhibits into evidence. The second part of the program is a workshop in which participants practice the skills covered in part one and receive constructive feedback on their performance. The workshop will take place at the LACBA/Executive Presentations Mock Courtroom, 281 South Figueroa Street, Downtown. Figueroa Courtyard reduced parking with LACBA validation costs $10. On-site registration will begin at 8:00 A.M., with the program continuing from 8:30 A.M. to 12:30 P.M. The registration code number is 009854. The prices below include the meal.

$350—LACBA members
$500—all others

3.75 CLE hours

Class Actions

ON THURSDAY, FEBRUARY 21, the Los Angeles County Bar Association will host a program on class actions and how attorneys who are not familiar with class actions can understand the basics and recognize opportunities. Speakers Alexander Barnett, Christopher Burke, Vincent J. Esades, Valerie G. Esch, Gregg A. Farley, and Daniel R. Karon will review how, with the litigation climate rapidly changing (especially regarding traditional tort remedies), it is more important than ever that attorneys know how to recognize class action claims. Once identified, attorneys then need to know how to get involved in these cases in order to better protect the rights of clients. This program is designed for attorneys interested in helping individual and business clients understand when they have been victimized in a manner creating class action claims—including situations involving consumer fraud schemes, price fixing or market allocation conspiracies, mass tort injuries, or wage and hour schemes. The program will take place at the LACBA Conference Center, 281 South Figueroa Street, Downtown. Figueroa Courtyard reduced parking with LACBA validation costs $10. On-site registration will begin at 8:30 A.M., with the program continuing from 8:30 A.M. to 5:00 P.M., with a break for lunch. The registration code number is 009809. The prices below include the meal.

$200—CLE+PLUS members
$340—LACBA members
$410—all others

6.25 CLE hours, including 1 hour of ethics credit

Los Angeles Superior Court Litigation Program

On Saturday, February 23, the Association, the Barristers Section, the judges of the Los Angeles Superior Court, and the Los Angeles Daily Journal will sponsor a program presented by judges and prominent trial attorneys offering a general overview of the Los Angeles Superior Court, Julie Bronson, John J. Collins, Judge Emilie H. Elias, and Judge Aurelio Munoz will share valuable ideas for successful pretrial and trial techniques and discuss common pitfalls to avoid in the courtroom. The first hour will involve court administration issues and alternate dispute resolution. Among the topics to be covered during the afternoon session are: opening statements, voir dire, cross-examination, and final arguments. Lawyers, law students, and paralegals are encouraged to attend. The following segments will be presented by Los Angeles Superior Court judges: the layout of the courthouse, alternative dispute resolution, and nuts and bolts. After lunch prominent trial lawyers will present parts of a mock trial based upon a medical malpractice hypothetical. Those who attend will learn how to avoid common errors in the courthouse and obtain valuable handouts (including a syllabus on seminar topics and court research attorney checklist forms).

The program will begin at 8:30 A.M. and continue until 3:45 P.M., with a break for lunch. Deadline for advanced payment is noon on February 8. The registration code number is 009809. The program will take place at Los Angeles Superior Court, 111 North Hill Street, Downtown. Parking is available at no charge at lot 17 (entrance is on the west side of Olive Street, just south of First Street). The prices below include continental breakfast and lunch.

$17—court staff
$30—law students
$45—paralegals
$55—CLE+PLUS members
$90—all others

$100—registrants after noon February 8, 2008

6 CLE hours
Reality MCLE

EACH JANUARY, MORE THAN 40,000 CALIFORNIA ATTORNEYS scramble to earn their last several hours of required continuing legal education credits. Most sit through interminable sleep-inducing seminars or, even worse, listen to the same sleep-inducing seminars on CD in their cars. Every year, those 40,000 attorneys collectively say to themselves, there has to be a better way to earn MCLE credit. For those attorneys who spend some or most of their time in court, the most valuable educational experience available unfortunately does not qualify for MCLE credit at all. That experience is jury duty, and the State Bar does not recognize it as worthy of MCLE credit, a defect in the regulations that should be changed.

Where else can a courtroom attorney learn the skills, methods, and strategies most applicable to his or her professional growth than a courtroom? Through service on a jury, attorneys can learn invaluable lessons about conduct in front of a jury: how the attorney and client should dress, how not to react to adverse or surprise testimony, even mannerisms and speech when selecting a jury. Attorney jurors become educated on the latest courtroom technologies, not in theory but in practice, where they can see which method for presenting evidence is most effective.

Participation in jury deliberations provides unmatched insight into what lay jurors focus on during the hours, days, or weeks of testimony, what they disregard, and, critically, which instructions they follow, fail to understand, or simply ignore. Having another lawyer or consultant tell an MCLE audience what impresses a jury is like listening to your neighbor narrate a slide show about a trip to Hawaii; the true experience can only be understood by walking barefoot on the beach.

The State Bar authorizes multiple means for California attorneys to receive MCLE credits, all of which are inferior to jury service. The dirty secret is that there is simply no accountability for attorneys who gain their credits in any of the approved fashions. Want to sleep through a seminar? Fine, you still get credit for being in the room. Choose to take a written test without reading the materials and miss every question? No problem, you will still receive a certificate. The State Bar deems it necessary for active members “to remain current regarding the law, the obligations and standards of the legal profession, and the management of their practices.”1 But the Bar certainly did not intend that the programs be boring or worthless, which is exactly what many of them are.

Jury duty could qualify for MCLE credit if a few small changes were made to the State Bar rules. First, the rules should clarify that judges and courts are qualified as approved “providers”2 of MCLE credit since they have “significant professional or academic experience related” to the activity, i.e., the trial.3 The current rules provide that if an activity takes more than one hour, “the provider must make substantive written materials available either before or during the activity.”4 This requirement should be waived for jury service, since some trials, especially most criminal matters, do not have any documents for the jury, and no trials have take-home materials for future reference. The lack of an outline of the “program” should not preclude MCLE credit. Also, the rules require that programs “must be scheduled so that participants are free of interruptions.”5 Anyone who has tried a case, or been a juror for that matter, knows that interruptions and delays are the rule rather than the exception. Again, in the context of jury service, this requirement could be revised appropriately so credit can still be afforded for the time that the attorney actually serves, rather than for breaks, just as for other accredited activities.

Jury service should also qualify for those hard-to-earn MCLE special credits, but again a few changes to the rules are necessary. An attorney who sits on a jury for a case involving driving under the influence or possession of narcotics should receive MCLE credit for substance abuse, since the testimony in such cases typically includes the same information about the effects of alcohol and drugs on a body as do more traditional MCLE programs. Similarly, an attorney juror in a case involving federal malpractice or options backdating approved by a corporate general counsel should be entitled to credit for ethics in the legal profession. An age or gender discrimination action involving employees of a law firm warrants credit for elimination of bias in the legal profession. The clerk could certify these special credits, just as the clerk currently verifies jury service for laypersons.

It does not take much imagination to understand why attorneys serving as jurors should be afforded MCLE credit. The State Bar recognizes MCLE credits offered by acting classes for attorneys, courses that discuss how attorneys are depicted in motion pictures through movie clips, and, as I recently found out the hard way, even 6.5 hours for an online traffic school. Given the valuable, real-world experience afforded by jury service, there really is no good reason why MCLE credit should not be given to attorney jurors.

2 Id. at R. 2.51(B).
3 Id. at R. 2.52(B).
4 Id. at R. 2.52(D).
5 Id. at R. 2.52(E).

Jerry Abeles, a business litigation partner in the Los Angeles office of Arent Fox LLP, has served on three juries.
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