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Los Angeles lawyer Mark Labaton explains the role of credit default swaps in triggering the collapse of the financial markets

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STEVEN L. GLEITMAN, ESQ.
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Mr. Gleitman has practiced sophisticated estate planning for 26 years, specializing for more than 14 years in offshore asset protection planning. He has had and continues to receive many referrals from major law firms and the Big Four. He has submitted 52 estate planning issues to the IRS for private letter ruling requests; the IRS has granted him favorable rulings on all 52 requests. Twenty-three of those rulings were on sophisticated asset protection planning strategies.
Even as Los Angeles Lawyer publishes this month’s special issue on the Economic Crisis and the Law, media reports are heralding signs of economic recovery. This is welcome news for all Americans; although each of us has borne the downturn in different ways and to different degrees, the recession has had a collective impact on our nation.

In the daily lives of citizens, however, the reports of economic recovery may seem more an invention of government statistics and Wall Street dreams than any reflection of reality. In fact, the effects of the economic crisis will be felt by Americans for months or even years after Wall Street and government return to business as usual. For attorneys, the legal issues raised by the intersection of recession and law will continue to play out in courts, in negotiations, and in the daily lives of our clients.

The causes of the downturn were complicated yet foreseeable, and foreseen. Still, business, consumers, and regulators alike turned a blind eye to signs of decay in the pre-2007 freewheeling economic atmosphere when the financial pie seemed limitless. But economies are cyclical and, when the bubble burst, personal wealth plunged and businesses scrambled to adapt. In the aftermath, some will seek to recoup their losses from those who engaged in the excesses, and there will be no shortage of potentially responsible parties, just as there is no shortage of victims.

While lawsuits seek to assign blame and establish retribution, many businesses will pay a steeper price. General Motors’ bankruptcy attracted press attention, but businesses of all sizes have closed their doors forever. Financial institutions also have been hard hit, with implications for a range of individual and business activities. For those financial institutions not aided by the Troubled Asset Relief Program, failures in 2009 occurred at a rate not seen since the Great Depression. These bank failures reflect underlying instability well beyond the customary concern of deposit insurance.

Beyond the financial products and institutional behaviors, there is a very human side to the economic crisis. Many jobs lost in this downturn will not be replaced, and it will be up to a resurgent economy to create new jobs in emerging fields. But a welder does not become a medical technician overnight, or perhaps ever; it takes time for employment dislocation to settle back into the “new normal.” While this happens, the downturn affects families and individuals in ways that are predictable, yet rarely given a face: cuts in social services, loss of medical care and access to legal services, and a decreased ability of families to pay the costs for their basic needs.

A single issue of our magazine cannot capture the full and dramatic depth, complexity, and speed of this historic collapse or predict the myriad ways recovery will lead to new growth and innovation. However, in this special issue we place under the microscope a representative sample of the wide-ranging effects of economic dislocation and correction.

Now, perhaps, there is light at the end of the tunnel, reminding us that, somehow, our economy always returns, a phoenix reborn from the ashes of its seeming demise. Our country has always been one of invention, where challenging times are the foundation of opportunity. With this in mind, the coordinating editors of this special issue look forward to a strong recovery in which our readers again find all the success and security they desire.
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The Risks of Provisional Patent Applications for Inventors and Startups

In 1995, the U.S. Patent and Trademark Office began offering inventors the option of filing a provisional application as a lower-cost alternative to filing a nonprovisional application for a patent. A provisional application allows the applicant up to 12 months to file a nonprovisional application that may be examined for patentability. A provisional application offers some benefits:

- Priority date upon filing.
- A prima facie prior art reference against subsequently filed applications for the same concept by a different inventor.
- No start to the 20-year patent term for the subsequently filed domestic nonprovisional application claiming priority to the provisional application.

For startup companies and solo inventors, as well as companies developing cutting-edge technologies in a competitive environment, a provisional application can be advantageous. Filing a provisional application also allows for the commercialization of a product or method (i.e., public sale) that falls within the scope of the provisional application, which may be especially important for a startup company or solo inventor.

After the Patent and Trademark Office began offering provisional applications, legal document preparation companies began offering help with filing these applications. These companies may attract startups or solo inventors with little capital by offering low prices that are possible because provisional applications are not examined by the Patent and Trademark Office for patentability. Even though a provisional application is a legal document, it never undergoes scrutiny for legal sufficiency unless it is challenged later—for example, in a patent dispute or during due diligence. These document preparation companies generally do not employ patent attorneys, who are the only attorneys legally authorized to practice before the Patent and Trademark Office in patent cases.

As set forth in 35 USC Section 112, at least one claim—which describes the new part of an invention—is required in a nonprovisional patent application. In contrast, a provisional application does not require a claim (although practitioners often include claims in provisional applications, for purposes such as preparation for foreign filings in foreign jurisdictions, which may require at least one claim in the first-filed application). However, even though a claim is not required in a provisional application, the written description and any drawings (i.e., the specification, which is everything but the claim) must adequately support the later-filed nonprovisional application if the later-filed nonprovisional application is to benefit from the provisional application filing date. It is the drafter’s duty to ensure that the provisional application adequately provides a written description of the full scope of the subject matter regarded as the invention and desired to be claimed in the later-filed nonprovisional application.

Although there is no requirement that the specification filed in the provisional application be identical to the later-filed nonprovisional application, the nonprovisional application is only entitled to the benefit of the provisional application’s filing date for the subject matter that the two applications have in common. Additionally, the specification must disclose the manner and process of making and using the invention—in such full, clear, concise, and exact terms as to enable any person skilled in the art to which the invention pertains to make and use the invention. Additionally, it must set forth the best mode contemplated for carrying out the invention.

This demanding but reasonable requirement casts doubt on the ability of legal document preparation companies to file a provisional application that will withstand later scrutiny. An inventor or startup that uses a legal document preparation service for filing a provisional application may wrongly assume that the provisional application is legally sufficient to support the subsequent nonprovisional application.

In New Railhead Manufacturing, LLC v. Vermeer Manufacturing Company, a representative case in which the legal sufficiency of the underlying provisional application was challenged, the Federal Circuit affirmed the district court’s finding of invalidity of the patent-in-suit based on the inadequacy of the first-filed provisional application. There was no dispute that the product falling within the scope of the patent-in-suit was the subject of a commercial offer for sale more than a year before the filing of the nonprovisional application that matured into the patent-in-suit, although the offer for sale took place less than a year before the filing of the provisional application (a public sale more than one year before the filing date of an application is a statutory bar to patent protection). However, the court found that the plaintiff could not rely on the provisional application for priority because of the inadequacy of its written disclosure. In view of the offer for sale, the patent-in-suit was deemed invalid.1

Attorneys with startups or solo inventors as clients should convey to them that a provisional application must meet legal standards. It would be devastating for a startup to file an inadequate provisional application that becomes the platform for a business, only to have the issued patent based on the provisional application invalidated due to a poorly prepared provisional application.

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BERNARD MADOFF WAS AN EQUAL OPPORTUNITY SWINDLER. He defrauded charities and schools; fleeced the wealthy, including many prominent financial and entertainment figures; and eviscerated the retirement savings of countless lower and middle-class individuals whose pension funds unwittingly invested in his Ponzi scheme.

Recognizing this financial damage, Internal Revenue Service Commissioner Doug Shulman, appearing before the U.S. Senate Finance Committee in March 2009, announced a plan for providing tax relief to Madoff’s victims:

The recent Madoff scandal has affected a very large and diverse pool of investors, some of whom are reported to have lost most of their life savings. Beyond the toll in human suffering—as entire life savings and retirements appear to have been wiped out—the Madoff case raises numerous tax and pension implications for the victims.

To help provide clarity in this very complicated and tangled matter and to assist taxpayers, the IRS is today issuing guidance articulating the tax rules that apply and providing “safe harbor” procedures for taxpayers who sustained losses in certain investment arrangements discovered to be criminally fraudulent.

By providing this guidance and safe harbor procedure, the IRS has helped alleviate the financial hardships suffered by taxpayers caught up in the unscrupulous investment schemes promoted by Madoff and others. At the same time, one must fully understand the recent IRS guidance, including the potential benefits and drawbacks of invoking the newly created safe harbor treatment, and be aware of potential complications of claiming Ponzi scheme losses for California tax purposes.

The IRS provides its guidance in Revenue Ruling 2009-9. After describing how a typical Ponzi scheme operates, the ruling discusses the technical tax issues involved in claiming losses incurred from these schemes. The Internal Revenue Code allows a deduction for losses sustained during a taxable year that are not compensated by insurance or other means. These losses are often characterized as “theft losses.”

The question of whether losses suffered from a Ponzi scheme constitute a theft is answered by the broad interpretation given the word, both by the IRC and relevant case law. For tax purposes, theft covers any criminal appropriation of another’s property to the use of the taker, including theft by swindling, false pretenses, and any other form of guile. A taxpayer claiming a theft loss must prove the loss resulted from a taking of property that was illegal under the law of the jurisdiction where it occurred and was done with criminal intent. The new revenue ruling cautions that, while victims of a Ponzi scheme may have incurred losses in the value of their stock portfolio, not all such losses qualify as a theft loss. If a person takes a loss in the sale of stock acquired on the open market for investment, this is generally considered a capital loss. And even if a stock declines in value because a corporate officer or director committed fraud, the loss would still not qualify as a theft loss because no one had the specific intent to deprive shareholders of money or property. In contrast, since the U.S. Department of Justice indicted Madoff based on his actions to deprive taxpayers of money through criminal acts, his actions constituted a theft for federal tax purposes.

The ruling makes clear that while a theft loss is an itemized deduction, some of the typical conditions applied to such deductions do not apply to theft losses from a Ponzi scheme. One waived condition is the 2 percent floor in determining miscellaneous itemized deductions. Also, theft losses from these schemes are not subject to the overall limitation on itemized deductions based upon a percentage of adjusted gross income or total itemized deductions.

A taxpayer sustains a theft loss during the taxable year when it is discovered. However, if an opportunity presents itself to obtain reimbursement that year and a reasonable prospect of recovery exists, no portion of the loss can be claimed until the year when it can be ascertained with reasonable certainty if reimbursement will actu-
ally be received. Thus, whether a reasonable prospect of recovery exists is a question of fact determined by examining all relevant facts and circumstances. The amount of the theft loss resulting from a fraudulent investment is generally the initial investment amount, plus any additional sums put in, less amounts withdrawn, if any, reduced by reimbursements or other recoveries. The loss amount is also reduced by claims for which there is a reasonable prospect of recovery. A taxpayer who has a theft loss from a Ponzi scheme would follow this calculation, including reporting amounts reported as gross income on the taxpayer’s federal income tax returns during the years of investment.

Theft losses are treated as business deductions and may be included in net operating losses that are carried back and carried forward. Taxpayers claiming net operating losses for the 2008 tax year are eligible for a net operating loss carryback period of up to five years, rather than the usual three-year carryback period for casualty or theft losses. However, this five-year net operating loss carryback period is restricted to “eligible small businesses” or corporations or partnerships having average annual gross receipts not exceeding $15 million for the three taxable years ending with the last taxable year. For theft losses incurred in years other than 2008, a taxpayer may carry such losses back three years and forward up to 20 years.

The New Safe Harbor

Although the ruling clarifies the law relating to a loss suffered from a Ponzi scheme, the optional safe harbor treatment provides a higher degree of certainty on theft loss claims and reduces the administrative burden on both taxpayers and the IRS in filing and processing claims. Revenue Procedure 2009-20 provides taxpayers with a means for claiming losses pursuant to the stated safe harbor and describes how the IRS will treat a return that includes a deduction for these losses when not following the safe harbor. The IRS recognizes that determining the availability of a theft loss and calculating the amount of such losses incurred in a Ponzi scheme during the year when the scheme is uncovered are highly fact specific. The optional safe harbor avoids this dilemma by enabling qualified investors to deduct this loss as a theft loss when certain conditions are met and provides a uniform manner for determining the amount of the losses. Investors no longer face the potentially difficult problem of proving how much income reported in prior years or a return of capital was illusory and alleviates compliance.

The safe harbor applies to a “specified fraudulent arrangement” which is defined as an arrangement where the “lead figure” or perpetrator receives cash or property from investors; purports to earn income for the investors; reports income amounts to the investors that are partially or wholly fictitious; makes payments, if any, of purported income or principal to some investors from amounts that other investors invested in the fraudulent arrangement; and appropriates some or all of the investors’ cash or property.

The safe harbor only covers qualified losses. These losses result from a “specified fraudulent arrangement” where the perpetrator was charged by indictment or information under state or federal law with committing fraud, embezzlement, or a similar crime which, if proven, would meet the definition of theft under the IRC. The safe harbor also applies when the perpetrator was the subject of a state or federal criminal complaint and that individual admitted the crime or a receiver or trustee has been appointed to take jurisdiction over the perpetrator’s assets.

The rules of the safe harbor establish a four-part test in defining who is a “qualified investor.” Under this definition, a qualified investor is a U.S. citizen, resident, domestic entity, or qualified trust that 1) was generally qualified to deduct theft losses under the IRC, 2) lacked actual knowledge of the fraudulent nature of the investment arrangement before it became known publicly, 3) invested in a specified fraudulent arrangement that was not a tax shelter as defined by the IRC, and 4) transferred cash or property to a specified fraudulent arrangement. A qualified investor excludes anyone who contributed to a fund or entity that then invested in the specified fraudulent arrangement; however, the fund or entity may fall within the revenue procedure’s definition of a qualified investor. For example, a partnership or other pass-through entity formed to invest in what subsequently turns out to be a specified fraudulent arrangement may avail itself of the safe harbor if it is under the alleged Stanford Ponzi scheme should be able to claim a loss under the safe harbor for the 2009 tax year.

The sum of the investment in a Ponzi scheme qualifying under the safe harbor is calculated as follows: The total amount of cash or property that the qualified investor invested in the arrangement in all years plus the total amount of net income “earned” from the specified financial arrangement that, consistent with information received from the specified fraudulent arrangement, the qualified investor included in income for federal tax purposes for years prior to the discovery year (including the taxable years when a refund would be barred by the statute of limitations) minus the total amount of cash or property that the qualified investor withdrew in all years from the specified fraudulent arrangement.

Under the rules, a qualified investment excludes 1) amounts borrowed from the operator of the scheme and invested in the specified fraudulent arrangement if they were not repaid when the theft was discovered, 2) fees paid to the operator and deducted for federal income tax purposes, 3) amounts reported to the qualified investor as taxable income that were not included in gross income on that investor’s tax returns, or 4) cash or property that the qualified investor invested in a fund or entity that invested in a specified fraudulent arrangement. Two specific amounts can be claimed as losses in the year of discovery under the safe harbor. A taxpayer victimized by a Ponzi scheme is permitted to take a loss equal to 95 percent of the qualified investment provided the taxpayer does not seek any third-party
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recovery for theft loss tax purposes. Alternatively, a qualified investor may claim 75 percent of the deductible loss if that investor is pursuing or intends to pursue a third-party recovery. In addition, the amount being deducted must be reduced by any actual recovery the taxpayer receives in the discovery year and any potential insurance or Securities Investor Protection Corporation recovery. Lastly, the qualified investor may have income or an additional deduction in a year subsequent to the discovery year, depending on the actual amount of the loss that is eventually recovered.

A taxpayer must comply with the procedures outlined in Revenue Procedure 2009-20 to claim safe harbor treatment. The taxpayer must mark “Revenue Procedure 2009-20” at the top of the IRS form used to report casualty and theft losses. Also, the taxpayer must complete and sign an Appendix A like that attached to the revenue procedure. By executing Appendix A, the taxpayer agrees to not 1) deduct in the discovery year any amount of the theft loss exceeding the deduction permitted under the revenue procedure, 2) file returns or amended returns to exclude or recharacterize income reported with respect to the investment arrangement in taxable years preceding the discovery year, 3) apply under the Claim of Right Statute, and 4) apply the doctrine of equitable recoupment or any form of statutory mitigation with respect to income from the investment arrangement that was reported in taxable years that are otherwise barred for filing a claim for refund under the statute of limitations.

Taxpayers Not Claiming the Safe Harbor
Revenue Procedure 2009-20 effectively directs taxpayers to follow the safe harbor treatment by reminding them of the burden of claiming a theft loss outside its provisions. This burden includes establishing that 1) the loss was from activities that qualify as a theft under the IRC, 2) the theft was discovered in the year the taxpayer claims the deduction, 3) the amount of the claimed loss, and 4) no claim for reimbursement of any portion of loss exists for which there is a reasonable prospect of recovery in the year in which the taxpayer claims the loss. Finally, the taxpayer filing amended returns attempting to exclude income in prior years must show that the income was not actually or constructively received by the taxpayer.

A potential downside may exist in choosing safe harbor treatment over the filing of amended returns to reverse “phantom income” previously reported from Madoff’s fraudulent brokerage statements. While a taxpayer maintains the burden of proving the income did not actually exist, federal authorities and others familiar with the Madoff case may have disclosed enough information to show that Madoff did not engage in any real trading and that his brokerage statements were fraudulent. Based on this, a taxpayer could claim that income included in prior tax returns should actually not have been reported and those returns that are still open by statute—three years from the filing of the federal tax returns and four years from the filing of state income tax returns—should be amended accordingly. If successful, refunds would accrue statutory interest from the filing of the subject returns. These refunds would be more beneficial than refunds following the safe harbor provisions because the latter only accrue interest from the year of discovery. Moreover, refunds from amended returns will typically be paid from higher tax brackets than refunds from the carryback of theft losses claimed under the safe harbor, which must offset income from the lowest tax bracket to the highest, before being carried into another year. A taxpayer would be well advised to have an accountant calculate the refunds, including interest owed by amending returns, compared with claiming a theft loss under the safe harbor provision.

A taxpayer claiming the safe harbor must also waive any deductions or claims that may be available under the Claim of Right Doctrine. Under this doctrine, if a taxpayer pays the tax on income in an earlier year and in a subsequent year the taxpayer is required to repay the income, the taxpayer may claim a deduction for such repayment. Recently, the trustee for Madoff’s bankrupt company began suing investors to claim tax refunds as compensation for fraud victims. These so-called clawback lawsuits seek to recover tax refunds on the theory that these same investors previously received distributions from Madoff that are now subject to disgorgement. As of August 2009, the IRS had not yet ruled on whether an investor who took advantage of the safe harbor and agreed to waive the benefits under the Claim of Right Doctrine can thereafter make such a claim when faced with a repayment of monies to the Madoff bankruptcy estate.

California Tax Treatment
The California Franchise Tax Board has announced that it will follow IRS guidance to taxpayers who suffer losses from Ponzi schemes. The FTB will accept Appendix A to Revenue Procedure 2009-20 for those choosing the optional safe harbor provision; however, a taxpayer who takes advantage of this provision for federal purposes is not required to do so for California. Also, California does not currently allow carrybacks of net operating losses, and carry forwards of such losses have been suspended until 2010. Therefore, California taxpayers
ers may only claim a theft loss in the year of discovery and carry it forward beyond 2010, assuming state law will then allow net operating losses to be deducted.

The IRS has responded to the plea for relief from the many individuals that Madoff victimized by creating safe harbor provisions that make it easier, both substantively and procedurally, to claim losses from Ponzi schemes. The IRS should be lauded for its expeditious response to one of the most devastating frauds in U.S. history. However, taxpayers should consult with their tax professionals to determine whether the safe harbor relief is the best alternative when compared to other options.

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3 I.R.C. §165(a).
4 Edwards v. Bromberg, 232 F. 2d 107 (5th Cir. 1956); see also Treas. Reg. §1.165-8(d).
6 I.R.C. §165(c).
7 See Rev. Rul. 77-17, 1977-1 C.B. 44.
8 I.R.C. §165.
9 See I.R.C. §67(b)(3), which excepts theft losses under I.R.C. §165(c)(2) from the definition of miscellaneous itemized deductions.
10 I.R.C. §68(c)(3) states that losses deductible under I.R.C. §165(c)(2) are excluded from the itemized deduction limitation.
11 I.R.C. §165(e).
12 Treas. Reg. §§1.165-8(a)(2) and 1.165-1(d); see also Treas. Reg. §1.165-8(c); see also Treas. Reg. §1.165-8(f).
13 Treas. Reg. §§1.165-8(a)(2) and 1.165-1(d); see also Jepson v. Commissioner, 128 F. 3d 1410 (10th Cir. 1997), cert. denied, June 8, 1998.
15 I.R.C. §172(a).
16 Treas. Reg. §§1.165-8(a)(2) and 1.165-1(d); see also Jeppson v. Commissioner, 128 F. 3d 1410 (10th Cir. 1997), cert. denied, June 8, 1998.
21 Rev. Proc. 2009-20 §4.02(1) and (2).
24 Rev. Proc. 2009-20 §5.02(2), 4.07, and 4.08.
26 Rev. Proc. 2009-20 §6.01(1); see Internal Revenue Service Form 4684, Casualties and Thefts.
29 See I.R.C. §1341.
31 Id.
32 See REV. & TAX. CODE §17276.9(a) for suspension of carryover losses for individuals and REV. & TAX. CODE §24416.9(a) for suspension of losses for corporations.
Assessing the Impact of the Recession on Family Law Matters

BANKRUPTCIES, GOVERNMENT BUYSOUTHS, high unemployment, and real estate foreclosures have dominated the news so dramatically in the past 12 months that keeping track of the new financial universe requires a scorecard.1 Equally worthy of monitoring is whether, or how, these changes have affected family law matters. Issues for examination include the unforeseen consequences of property divisions that are now drastically inequitable, child and spousal support arrangements that involve materially changed circumstances, and custody disputes that include requests to relocate the children.

Counsel should be aware of a basic principle in family law: Property settlement agreements, even those bearing the impact of recent economic conditions, are not subject to modification based on grounds of equity, surprise (by the moving party), or basic fairness. Motions to set aside property divisions because the economy went south are not likely to prevail. The only set-aside motions with the possibility of success are those that allege and prove nondisclosure of material information.

Under Family Code Section 2122, the court may set aside a judgment based on actual fraud, perjury, duress, mental incapacity, or mistake.2 The court’s discretion is limited because Family Code Section 2123 provides that “a judgment may not be set aside simply because the court finds that it was inequitable when made, nor simply because subsequent circumstances caused the division of assets or liabilities to become inequitable, or the support to become inadequate.”3

Traditionally, set-aside motions in California family law courts were governed by Code of Civil Procedure Section 473 if they were filed within six months after the entry of judgment. After that six-month period, parties brought set-aside motions under the common law of extrinsic fraud.4 The “473 motion” and Family Code Section 2122 now coexist, operating as alternative bases for relief depending on when the application is filed. Within the six-month time limit under Section 473, a litigant may seek relief from a family law judgment under either the statute’s mandatory provisions—whereby the litigant’s attorney is willing to swear to his or her own fault—or its discretionary provisions—under which the court may relive a party of the consequences of his or her own mistake, inadvertence, surprise, or excusable neglect. Alternatively, a party may seek relief under any of the specific grounds specified in Family Code Section 2122.

California case law does not support judicial revision of property settlement agreements because of unforeseen economic developments. For example, in In re Marriage of Heggie, the court of appeal held that a subsequent increase in the value of stock received by the husband could not be the basis to set aside the judgment.5 The wife in Heggie had filed a motion to set aside that part of the judgment dividing the community property in the couple’s respective IRA accounts. She presented evidence that since the stipulated judgment, the value of one of the high-tech stocks that her husband received had increased 140 percent and another had increased in value by 250 percent.6 The trial judge granted the motion and ordered that portion of the judgment regarding the division of the IRAs to be set aside. The court of appeal reversed the trial court, ruling that stock market fluctuations cannot serve as the basis for a set-aside motion: “[I]n sum, there was no substantial reason other than the prospect of [the] husband’s windfall to support the set aside motion….We are left with the naked lopsidedness of the deal in hindsight, and under section 2123 that is not enough.”7 (See “A British Analogy,” page 16.)

Nevertheless, if evidence of the bad economy is part of a claim that includes and emphasizes a failure to disclose, the party seeking relief from a settlement or judgment may find favor with courts. Courts of appeal in California have found the lack of full and accurate disclosure to be a basis to set aside a judgment. In In re Marriage of Varner, the trial court denied the ex-wife’s motion to set aside a judgment on the grounds that her husband had failed to disclose the extent or value of the community property.8 The court of appeal reversed, relying on the duty of disclosure required by Family Code Section 2102.9 Similarly, the court of appeal in In re Marriage of Brewer and Federici affirmed a set aside based on the wife’s failure to make a full and accurate disclosure of her pension plans.10 These cases as well as In re Marriage of Rosevear suggest that evidence of an economic crisis may facilitate claims that the failure to disclose resulted in a material disadvantage to the moving party.11

Child and Spousal Support Orders

The economic downturn will most likely have a greater impact on child and spousal support orders than settlements or judgments involving property. The loss of employment is an obvious ground for seeking modification of a support obligation. In addition, step-down orders based on the expectation of future employment may be more difficult to obtain because of the uncertain economy.12 When this type of order already exists, it may be subject to modification because the underlying assumption of future income may not be realized.13 It has been suggested that courts should be more aware of the economy when considering requests to impute income under Family Code Section 4058(b), which provides that the “[c]ourt may, in its discretion, consider the earning capacity of a parent in lieu of the parent’s income, consistent with the best interests of the children.”14 Pursuant to In re Marriage of Bardzik, imputation may be appropriate upon a showing of ability and opportunity to work.15 In the context of staggering unemployment figures, courts may be reluctant to impute income without irrefutable evidence that a job actually awaits an unemployed party:

[S]pecifically, in satisfying the “opportunity to work” prong of the Bardzik test, should a parent seeking to impute income to the other parent be required to prove not only that jobs within the other parent’s ability are available, but also that the other parent would actually be hired for one of those jobs? This has not been the law generally....But in an economy where fewer

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The impact of the economy will also be felt when modification proceedings focus on the supported spouse's efforts to attain self-sufficiency. In In re Marriage of Sheridan, the court held that the supported spouse's failure to diligently pursue employment constituted a change in circumstances sufficient to justify a termination of spousal support. However, the concept of due diligence may be measured differently in an economic climate marked by significant unemployment. The court in In re Marriage of McClure extended the supported spouse's due diligence to the prudent management of his or her separate property estate. But whether a supported spouse was prudent before and after the global financial collapse is an issue that will be viewed differently than it was during stable economic times.

Pursuant to In re Marriage of Richmond, trial courts often attempt to fashion support orders to encourage supported spouses to become self-sufficient. In Richmond, the court of appeal affirmed the trial court's order to pay support for three years unless the wife could show good cause to extend it. Trial courts may be reluctant to make Richmond orders in the context of an uncertain economy. For those cases in which Richmond orders were in place before the economic nosedive, the burden of the supported spouse to show good cause for the extension of support may be easier to meet due to high unemployment.

**Custody Proceedings**

The economy also may play a role in custody matters, particularly move-away cases. The California Supreme Court, in In re Marriage of Burgess, placed an initial burden of proof on the noncustodial parent to prevent the cust-
A party that seeks to move away with the children because the party has employment opportunities or needs to reduce his or her cost of living may have little difficulty in convincing the court that the proposed move is in good faith. However, under LaMusga, the court must consider the distance of the move and the reasons for the proposed move. In analyzing the factor of distance, evidence that the stay-behind parent does not have sufficient financial resources to assure frequent contact with the children may tip the balance in favor of the stay-behind parent. But if the proposed move is due to a job waiting for the custodial parent, the stay-behind parent will have more difficulty arguing that the move is not for a legitimate reason.

The impact of the recession may be a significant factor in the resolution of support and custody issues. However, parties should not expect to receive relief when they seek to set aside property agreements that are no longer equitable because of the economy.

1 The New World, WORTH, Spring-Summer 2009, at 58.
2 FAM. CODE §2122.
3 FAM. CODE §2123.
6 Id. at 32.
7 Id. at 36.
9 Id. at 144.
12 See, e.g., In re Marriage of Ackerman, 146 Cal. App. 4th 191 (2006) (spousal support ordered terminated based on evidence that the supported spouse would earn a set amount in the future).
16 Liebman & Gamblin, supra note 14.
19 In re Marriage of Richmond, 103 Cal. App. 3d 352 (1980).
20 Id. at 356.
21 In re Marriage of Burgess, 13 Cal. 4th 25 (1996).
23 Id.
Starting a Law Practice in a Home Office

**EVEN IN THE BEST OF TIMES** there are good reasons to operate a solo legal practice from a home office. But in a recessionary market, there may be an even better reason. By August 10, 2009, more than 10,000 lawyers had been laid off from large national firms nationwide. The number is even higher when smaller firms and corporate law departments are considered, as well as job losses resulting from firm and corporate closures. With approximately 11 percent of California’s labor market unemployed (defined as those filing claims for unemployment benefits), there is no safe haven, as private practitioners, public interest lawyers, in-house lawyers, government lawyers, and even legal educators are all at risk.

However, setting up a solo practice from a home office has its own share of burdens. Among them:

- Tax considerations, especially the home office deduction and the self-employment tax.
- Professional insurance.
- Business development.
- Operating practices (income and expense tracking, billing, filing, conflicts checking, and tickler systems).
- Selecting and establishing a plethora of technology hardware and services.

The home office deduction allows a taxpayer to deduct as an itemized expense that portion of apartment rental or home mortgage costs (and related utility costs and other verifiable upkeep and maintenance expenses) attributable to the amount of the home that is used regularly and exclusively (and the IRS pays attention to “exclusively”) as the principal place of business, or for client meetings or business-related storage. The amount of space that may be calculated for purposes of the deduction is not limited in size and may consist of the square footage of a file cabinet to several rooms or a separate structure.

The self-employment tax can be a real surprise. This tax, required under the Internal Revenue Code, is the part of the Social Security and Medicare tax that an employer pays on behalf of its employees. The sole practitioner is employer and employee, and so must pay both halves of the tax. It must be estimated for the year based on anticipated income and then paid in four quarterly installments with IRS Form Schedule SE. If the attorney is making less than expected, the estimated amount can be reduced at the time of the next quarterly payment, and the payment adjusted accordingly. Of course, in the happy event that the attorney earns more than expected, the estimated amount, and the quarterly payments, must be adjusted upward. At the end of the year, when the attorney files his or her annual tax return, the final amount of self-employment tax is calculated based on actual income earned, with overpayments being reimbursed or applied to the next quarterly installment, and underpayments being made up or included in the next quarterly installment.

One benefit of being a sole practitioner is that virtually every business-related expense is tax deductible from the income of the business. This includes half of the year’s total self-employment tax, premiums for malpractice insurance, marketing and advertising expenses, business development expenses (including lunches, so long as substantive business discussion occurs), continuing legal education expenses, and operating and technology expenses. A law firm employee, on the other hand, often pays some or many of these same costs but cannot take the deduction unless the expenses are unreimbursed by the employer and exceed 2 percent of the employee’s adjusted gross income.

There are several providers of professional liability (or malpractice) coverage, and it pays to shop. Coverage is not cheap and will depend on the location of the practice, its type, and the age or experience of the practitioner. California lawyers are not required to carry malpractice insurance, and some sole practitioners choose to go without. However, the practitioner who incorporates as a professional law corporation or forms a limited liability partnership must carry malpractice insurance or provide other financial responsibility arrangements. Providers referred to lawyers through the California State Bar may offer a program for part-time lawyers (generally based on total hours worked, billed and unbilled). Since the home office solo may not generate a full-time work load, the part-time program can save thousands of dollars.

**Business Development**

Working from a home office offers many conveniences but also carries with it the possibility that clients or strangers will appear at one’s home for unscheduled meetings. In addition, mail services and private delivery companies may appear at inconvenient times. Having a residential address as a business address also may appear less professional and may lead to increased junk mail and invasions of privacy.

To create a separate business address without incurring the expense of renting office space, the attorney can rent a private postal box. In most cases, the address available through a private postal service is the street address of the location plus a suite number. The private box approach offers advantages over the U.S. Postal Service, which requires the use of the P.O. Box designation and does not accept private courier deliveries. Additionally, many subscription, online services, and delivery services (such as Federal Express) require registration using a street address and not a U.S. Post Office box. The rental fee for these private boxes is generally low, and to save money, the attorney can rent the smallest box available, and the store will hold larger

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include prospective clients or prospective referrals. For attorneys with children, children’s events and school activities also offer opportunities to meet new people and create new relationships. Sports activities have long been recognized as a way to create new business opportunities.

To network is to plant seeds. Although the lawyer may get lucky and attract immediate business, most networking requires time and nurturing to pay off. But it is usually well worth the effort, since the business it develops is founded on personal relationships, respect, and mutual cooperation.

There is nothing wrong with business development or even client meetings that include entertaining at home. However, for most business meetings the sole practitioner working from a home office is just as interested in creating a professional environment as the practitioner working from offices outside of the home. Fortunately, around Los Angeles it is possible to rent flexible-space meeting rooms and offices. These facilities are equipped with parking and communications services and will usually be disability accessible, have audiovisual capability, provide some degree of food and beverage service, and include access to a receptionist. This allows a practitioner of any specialty to host meetings, negotiations, closings, depositions, and other functions in a fully professional environment.

Operating Practices

A disadvantage of the home office is the lack of staff to tend to mundane tasks. Managing paper flow, invoicing, and accounting all become the responsibility of the attorney. If one has family members—especially those in adolescence—at home, then a ready labor pool may be available for nonlegal work at an agreeable price that, if managed properly, can also offset funding the extracurricular activities of those same adolescents. Also, technology can come to the rescue once again, reducing the need for filing and for significant paper invoicing, among other things.

Nevertheless, the home office sole practitioner will need to develop a few systems. For one thing, the attorney will need to track income, expenses, billings, and reimbursements. Most unreimbursed business-related expenses will be tax deductions, and credit providers will want to see well-organized financial reporting, so the attorney will want to keep careful records. A simple Excel spreadsheet can be created to track financial matters for recurring and nonrecurring categories on a monthly basis. Retail programs can also be purchased to accomplish this task. Remember, though, that time will be spent installing, learning to use, and troubleshooting the retail program.

In most commercially available programs marketed for legal practice, expense and income tracking and legal invoicing are combined in an integrated suite. Before spending money on these programs, however, make sure they are compatible with any electronic invoicing programs that clients may be using. Electronic invoicing requires that billing information be prepared in a specified format and uploaded to the electronic system, and these electronic systems sometimes are limited in the technologies with which they are compatible. Also, it pays to shop around for these invoicing programs, as many are very sophisticated and include features the home office practitioner would probably rather pay an accountant to perform.

Even though electronic storage may limit the need for paper storage, even digital files need a system of labeling. It is advised to use a uniform system of creating and naming digital file folders. Although over the course of a few months it may seem a simple case to remember where various documents or communications are stored, over many months or even years, it will be vastly more difficult to find randomly named or filed items.

It may be impossible to completely avoid paper files, although scanners today—either for home purchase or available for per page use at copy services—make it at least feasible, although potentially time-consuming. If paper files are retained, the home office practitioner will need to allocate accessible space for the files, use the same uniform system of file naming as is used for digital files, and develop a policy for file retention. To avoid too much paper, request those transmitting information to do so in PDF or another digital format rather than in paper copy.

Checking conflicts is another function that the sole practitioner will have to manage on his or her own that may have previously been the province of a law firm employee. Many sole practitioners either formally or informally cocounsel with other sole practitioners or small firms. Prevailing wisdom is that when an attorney works of counsel with another lawyer or firm, even while maintaining his or her separate solo practice, clients of the other lawyer or firm can create conflicts for the solo practitioner. Thus, the solo should also check conflicts with his or her cocounsel relationship.

The same may be true for attorneys who maintain a solo practice but also perform temporary or contract legal work for firms or corporations through a temporary services provider or through their own contacts. In fact, sole practitioners may find conflicts arising from a variety of other activities, such as engaging in business with clients or nonclients; engaging in nonlegal services for family, clients, or others, such as real estate sales or purchases, investment advising, accounting services, providing medi-
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One of the most significant areas of malpractice for sole practitioners is missed deadlines or hearing dates. Therefore, the attorney also needs to set up a calendaring and tickler system. Computer-based calendaring systems include an early reminder function for important deadlines or dates that can be set hours or days in advance. Calendaring the same item as a reminder over successive days or weeks is also a useful tool. Finally, it is helpful to determine if a calendar function, online or otherwise, coordinates with other personal devices. Before paying for a calendaring function, consider whether it is really any improvement over the available free services.

**Technology and Services**

The good news for today’s home practitioner is that amazingly powerful information processing, data management, and communication tools are as close at hand as the local office supply store or the Internet. The large infrastructure of technology equipment that a law firm used to require, and many firms still maintain, can reasonably be contained today in a personal computer, a four-in-one printing device, a handheld personal communications device, and a regular land line telephone, combined with use of services available from communications providers and Internet services. While the up-front costs of the hardware and services are relatively low, there will also be monthly costs, and an attorney establishing a new practice should be sure to budget the recurring costs and not just contemplate the one-time acquisition or leasing costs.

Selection of computer hardware, software, and peripherals has a significant component of personal preference. An attorney acquiring a computer for the home office probably will not require either a gaming computer loaded with top-end graphics or a netbook computer that maximizes the Internet experience but is light on office functions and disk drive storage. A desktop or laptop with a desktop docking station and LCD monitor will likely serve the sole practitioner better. A laptop is a good option because portability does not just mean taking the computer outside the home to meetings, hearings, and other work events, but also to conferences, while traveling, and even from room to room in the house. In addition to considering the basic computing power of the computer’s processor, the attorney also should check its capacity to drive more than one monitor so as to allow the use of a dual monitor.

Two monitors can reduce the time spent physically and mentally switching between windows, and a dual system can be had at a price that will not break the bank. Also, do not skimp on the size of the monitor. A 19-inch monitor is a minimum recommended size for reading documents, and bigger really is better, at least to a point. Of course, for the attorney who wants to track monitor size to the extreme, most of today’s wide-screen televisions also come with computer monitor connections—in case anyone really wants to see an employment agreement on a 60-inch television.

Disk space will be of enormous importance for storage of documents, reports, correspondence, and other client and administrative materials, as there is little need today for a sole practitioner to keep many paper files. Inexpensive external hard drives of phenomenal capacity are preferable over the built-in hard disk drive for storage of files that do not need to be accessed regularly. It is important to back up digital information. Everything should be kept on at least two separate drives. Brand name disk drives are generally of good quality, but they are not infallible and do not last forever. In addition, online services are available at a modest cost to store data on a remote server. It is recommended to utilize such a service to make sure that critical information is not lost in the event of a casualty or theft at the home office.

Regarding software, at least the standard version of the Microsoft Office suite is recommended. Excel and Power Point are increasingly useful for business, and the small business version of Publisher is also desired for somewhat professional looking marketing materials. Microsoft Works is not recommended. It fulfills the adage that you get what you pay for, as it is a much less robust version of Office, stripped of features seemingly at random, and it will in the long run cause more frustration than the cost savings justify.

It would be nearly impossible to survive in business without electronic mail. Although Microsoft’s Outlook is a popular business program for managing e-mail, it is neither the most cost-effective nor simplest to manage for the sole practitioner. The easiest e-mail access to set up is arguably one provided by popular Internet portals, such as Gmail, America Online, Yahoo, or Hot Mail. However, for a more professional address than name@aol.com, the sole home office practitioner should consider setting up an e-mail address through a Web hosting company that offers e-mail along with bandwidth and disk space. Using a Web host as an e-mail address allows the practitioner to blend an e-mail address and Web site, resulting in an address such as name@firmname.com.

Another consideration for the home-based solo when contracting with an Internet service provider is to obtain the highest bandwidth connection available. Some providers are establishing fiber optic systems (FIOS) in urban and suburban areas, which is a good choice for connection speed because fiber
optics do not suffer from the transmission loss over distance that electron-based systems do. Digital subscriber lines (DSL) and regular cable (broadband) connections offer very acceptable and widely available alternatives. For those whose neighborhoods are not served by these technologies, satellite connections offer the next best choice, but are not in the same speed class. A dial-up connection is not an acceptable alternative because it lacks the bandwidth to manage today’s communications.

Home wireless systems are also available at low cost, and these can make every room in a house part of the home office. For attorneys using laptops, a wireless connection and an Internet access card may be a desirable expenditure. Most laptops come with wireless capability, but using them to access the Internet for free is a hit-and-miss proposition. Access cards are expensive but necessary for an attorney who is often away from the home office and wants reliable full computer access to e-mail, research, the Internet, and other services.

The telephone is now probably second to digital transmission (e-mail and texting) in communication popularity. However, it is still an important tool and is not used as often as it should be. Unless the attorney’s home is in an area with clear cell phone reception, relying solely on a mobile phone is probably not a good idea. Land lines tend to have better speaker clarity. Otherwise, extra features are generally not much different (call waiting, call forwarding, caller ID, and conference calling).

The traditional phone company is not the only option for land line phone service today, and where available, voice over Internet protocol (VoIP) can be an attractive option. VoIP services meld electronic mail and the telephone, allowing for calls to be routed through other phones and sending voice messages to electronic mail accounts or to phone text messages. These features assure that the home office practitioner never misses an important call or message.

Land lines may be useful, but no attorney today should go without the ubiquitous cellular phone, or more likely a combination device that along with voice telephony offers e-mail access and various software for scheduling, notes, Internet access, music, photography, and myriad other features. The Blackberry is still cited as among the more business-friendly devices.

Conference calling has gained popularity as a means of doing business while saving travel costs. Even many court hearings are conducted by telephone. While there is still no substitute for face-to-face meetings to establish a rapport and to pick up subtle cues, telephone conferences are a fact of business life. Phone companies and private providers
offer conference calling services on a variety of plans. Similarly, Internet meetings are available through a variety of providers. Even meeting schedulers can be obtained through free online services.

The home office practitioner with a computer, land line, and cell phone does not yet have all the communication devices he or she may need. For home office purposes, a multifunction machine that provides printing, copying, faxing, and scanning should also be considered. Pay attention to the page-per-minute speed of the printer and copier functions. Scanning speed is usually less important for attorneys. Fax speeds are standardized and are less important when e-mail is the preferred form of sending documents. A flatbed page feeder is desirable when copying projects involving materials that cannot be fed through the feeder. Of course, copy service retailers still abound in most communities should a large copy job or other printing or photo services be needed.

Installing and servicing all this technology can bewilder anyone. Technology that comes with 24-hour support available from multiple sources (such as Internet, telephone, and on-site) is advisable. This will not solve every problem, as the responsibility for many technology issues is often difficult to discern between hardware and software makers. Note that a service plan is not the same thing as an extended warranty, which is generally not recommended by anyone except the person selling the warranty.

**Legal Research**

Once the technology is installed and running, the home office attorney may finally turn to the practice of law, which involves legal research. Every published case, statute, regulation, draft law, rule, major treatise, journal, news source, and reporting service is available online, although on the Internet as elsewhere, you get what you pay for. Subscriptions to Lexis or West will satisfy most research needs (although many secondary sources require payment of an extra charge). But some popular practice guides, such as California’s Continuing Education of the Bar practice books, are only available from the publisher. Since these can be expensive (especially when the annual updates are factored in), it is wise to select those in one’s practice area—although attorneys admitted to practice less than five years can obtain free access to CEB’s OnLaw legal research system. All CEB resource materials are also available on CD-ROM. Los Angeles County also maintains a substantial legal research library at its Downtown branch, as well as facilities at nine other courthouse locations. Use of these facilities requires payment of a nonrefundable annual borrowing fee and a refundable security deposit.

There are myriad resources available to the home office sole practitioner, who can be as well connected as any lawyer in a firm, corporation, or other environment. However, the sole practitioner working from home will need to do some serious planning for the diversity of activities that come from managing one’s own practice, and will benefit from openness to alternatives and flexibility in problem solving.

2. 26 U.S.C. § 280A.
3. See BUS. & PROP. CODE § 1671 (professional law corporations); CORP. CODE § 16556 (limited liability partnerships).

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**RISK CONTROL STRATEGIES**

**PENDING LITIGATION REQUIRES A RESULT ORIENTED RESOURCE**

- **LITIGATION SUPPORT**
- **COMPUTER FORENSICS**
- **TECHNICAL SURVEILLANCE COUNTERMEASURES (SWEEPS)**
- **WORKPLACE INVESTIGATIONS**
- **DUE DILIGENCE**
- **THREAT ASSESSMENT**
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In “Echoes of the Jazz Age,” F. Scott Fitzgerald describes how a long era of prosperity came to a halt with the stock market crash. “It ended,” he observes in this essay, “because the utter confidence which was its essential prop received an enormous jolt.” Fitzgerald’s description fits both his time and ours.

The Panic of 2008 jolted public confidence after years of good times. The continuing perilous status of banking and insurance institutions has been made considerably worse by their use of financial contracts and instruments known as derivatives. Those causing particular distress are “credit derivatives”—and the two types of credit derivatives most responsible for deepening the financial crisis are collateralized debt obligations (CDOs) and credit default swaps (CDSs or swaps). Both the CDO and CDS markets grew by leaps and bounds over the past decade, and these instruments pack a double wallop because they are so frequently intertwined.

Until recently, however, few Americans outside the financial community had heard of either CDOs or CDSs.

Derivatives are financial contracts, or instruments, whose values are derived from the price of something else. The underlying value of the derivative can be based on the price of any asset. For instance, it can be based on the value of a stock, a commodity, real estate, a loan, a bond, or a host of other assets. Credit derivatives are securities whose values are derived from the credit risk on an underlying bond, loan, or other debt instrument or contract.

CDOs are structured asset-backed securities—often bonds or loans—whose value and payments are derived from underlying pools of mortgages or other assets such as bundled corporate loans, automobile loans, and credit-card receivables. CDOs are created by issuers, typically an investment bank. The issuer forms a “special purpose entity,” which gathers the underlying assets and then divides

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them up into various pools known as tranches. Each tranche is separately rated by one of the credit rating agencies, and the securities in that tranche are then marketed and sold. Mortgage-backed securities are a common type of CDO.

CDSs are insurance-like contracts covering losses on debt instruments. Typically, they cover losses resulting from a default of a corporate bond. These bonds can, of course, include CDOs.

Estimates of the value of the CDS market, which is not regulated, vary substantially from slightly over $40 trillion to more than $60 trillion.\(^3\) To put these numbers in perspective, in 2008 the gross domestic product for the United States was $14.28 trillion.\(^4\) Thus, the CDS market is at least three times the size of the U.S. economy.\(^5\)

CDSs are written contracts in which one party buys “protection” in case a “credit event” occurs. “Credit events” are adverse occurrences such as defaults, write-downs, credit downgrades, bankruptcies, or restructurings of the company issuing the bond or other debt instruments covered by the CDS. The seller of the “protection” collects periodic payments over the course of the contract—much like insurance premiums. CDSs commonly cover a period of five years.

The CDS seller is exposed to several risks. First, there is the risk of default or some other credit event. Second, CDSs require the seller to post collateral if the protected securities decline in value or the sellers’ own corporate-debt credit rating is downgraded. Third, the seller must account for these contracts in its financial statements based on their market value. This means that when their value declines, the seller must write down that value on its books, which itself can impair the seller’s credit rating.

As international financier George Soros sees it, unregulated derivatives can “destroy society.”\(^6\) Fellow billionaire Warren Buffett calls them “financial weapons of mass destruction.”\(^7\) Not to be outdone, financier Felix Rohatyn says they are “financial hydrogen bombs.”\(^8\)

Although hyperbolic, these are strong words from three savvy businessmen. Surely, derivatives cannot kill millions of people instantly like, say, a hydrogen bomb—and credit derivatives are sometimes very useful. But they also can be deceptively dangerous. Left unregulated, they pose systemic risks to our economy.

Frank Partnoy, who now teaches at the University of San Diego Law School, sold credit derivatives for Morgan Stanley in the early 1990s and soon thereafter became an early critic of them. Partnoy acutely summarizes what went wrong in the epilogue of his recently republished book *F.I.A.S.C.O.*

**Blood in the Water on Wall Street:**

Without derivatives, leveraged bets on subprime mortgage loans could not have spread so far or so fast. Without derivatives, the complex risks that destroyed Bear Stearns, Lehman Brothers, and Merrill Lynch and decimated dozens of banks and insurance companies, including AIG, could not have been hidden from view. Without derivatives, a handful of financial wizards could not have.gunned down major mutual funds and pension funds, and then pulled the trigger on their own institutions. Derivatives were the key; they enabled Wall Street to maintain its run until it was too late.\(^9\)

“Without derivatives,” he adds, “the total losses from the spike in subprime mortgage defaults would have been relatively small and easily contained.”\(^10\) The reason for this is that the total decline in the value of subprime loans in 2008 was no more than a few hundred billion dollars, which is less than 1 percent of the market decline that year. Derivatives “multiplied the losses from subprime mortgage loans, through side bets based on credit default swaps. Still more credit default swaps, based on defaults by banks and insurance companies themselves, magnified losses on subprime side bets.”\(^11\)

Bankers, investors, and others lost confidence in financial valuations and in the ability of CDSs to provide protection against risks. Partly as a result, confidence in the financial system plummeted, credit markets froze, and the federal government was forced to spend trillions of dollars to prop up failing financial giants and to stimulate a severely damaged economy.

At best, CDSs are a form of unregulated insurance; at worst, they are a form of unregulated gambling. CDSs are valuable tools for hedging. They originally were (and still are) bought and sold by banks, insurance companies, hedge funds, and other financial entities to hedge against potential losses. The same entities sometimes both buy and sell the CDSs. Hedges, for example, are used by importers and exporters concerned about fluctuations in interest rates and currency rates, as well as by airlines and trucking companies concerned about fluctuations in oil prices, farmers concerned about fluctuations in seed prices, and manufacturers concerned about fluctuations in energy prices.

Over time, CDSs have increasingly become speculative instruments and thus pose grave threats. In instances when CDSs have been used to speculate, some of those placing winning bets have made fortunes, while those placing many of the biggest losing bets have managed to pass the costs of their gambles on to taxpayers as well as to the shareholders of the companies selling the CDSs.

Although marketed as a tool of shifting and limiting risks, CDSs have spread those risks in an uncontrolled manner to become a financial virus—an imperfect though perhaps more accurate analogy than that of nuclear weapons. The virus caught many regulators, politicians, and business leaders by surprise, and its widespread and severe effects could get worse. Indeed, the United States is suffering through an epidemic that could turn into a pandemic.

CDSs currently cover trillions of dollars of toxic assets, including CDOs that could still default or otherwise become impaired. The CDSs pose systemic risks because of their prevalence, the variety of ways they can easily be created, and the lack of regulatory oversight over them. They threaten our financial system and economy as long as they remain opaque instruments created and sold in shadow markets.

**Insurance Versus Swaps**

A comparison between insurance contracts and CDSs is illustrative. Insured parties must disclose certain known risks, and insurers can only insure tangible, ascertainable interests belonging to an insured party, such as an insured party’s home, car, or life. These constraints are not applicable to CDSs.

“Naked swaps” allow entities to insure—or make side bets on—interests for which the insured party holds no ownership interest. They are, therefore, a gamble on the creditworthiness of parties who have nothing to do with the underlying contract.

This is comparable to someone buying a life or fire insurance policy not on his or her own life or home but on the life or home of another person, such as a neighbor. If this type of insurance were available, the policyholder would win the bet if the neighbor died or the neighbor’s home caught fire. But rules forbid these types of policies, and sound public policies underlie their prohibition. Insurance is a regulated industry, but the same is not true for CDSs.

Moreover, with regard to CDSs, the number of side bets that may be placed is not limited by law. Indeed, an infinite number of naked swaps can be written. Not just, say, 10, but even 10,000 or more such bets can be wagered that a given bondholder or lender will default or otherwise become impaired. Insurers must maintain capital reserves for a predictable number of potential losses so that if a disaster—such as a hurricane or a flood—occurred, the insurer could cover its policyholders. Similarly, banks can only make loans if they first segregate a set amount of reserves to cover potential defaults on these loans. The reserves a bank is required to maintain increases in proportion to the num-
tation that swaps can create: holders, Warren Buffett described the devas-

annual report to Berkshire Hathaway share-

control. 

that feed off each other and spiral out of 

ter, a chain reaction can ensue, with problems 

grades in the company’s credit rating. In other 

could result in additional down-

large enough, the credit rating agencies will 

downgrade the company’s own credit rat-

This means that instant drops in the 

value of CDSs or demands to post additional 
collateral will result in write-downs by the 

CDS seller. When these write-downs become 
large enough, the credit rating agencies will 
downgrade the company’s own credit ratings 
possibly requiring it to post even more collateral and take further write-downs on its 

CDSs. This could result in additional down-

grades in the company’s credit rating. In other 

words, when the swaps default, or even fal-
ter, a chain reaction can ensue, with problems 

that feed off each other and spiral out of 

control. 

In this way, CDSs have devastated many of the companies that sold them. In his 2002 
annual report to Berkshire Hathaway share-

holders, Warren Buffett described the devas-
tation that swaps can create:

[They are] time bombs both for the 

ies that deal in them and the econ-

system….Unless derivative con-

tracts are collateralized or guaranteed, 

their ultimate value depends on the 

credit worthiness of the counter-parties 
to them. But before a contract is set-
tled, the counter parties record profits 
and losses—often in huge amounts— 
in their current earnings statements 
without so much as a penny changing 

The range of derivatives contracts 
is limited only by the imagina-
tion of man (or sometimes, it seems 

madmen). 

A number of the events posited by Buffett, occurring in rapid succession, created the 
perfect storm that brought AIG to its knees— and AIG almost took the American econ-

omy down with it. When AIG, a worldwide 

insurer with employees in 130 countries, 
became insufficiently solvent to post required 
collateral and pay off defaulted CDSs, the fed-
eral government assumed those obligations at 
a cost, so far, of more than $182 billion. 

At the same time, many of the largest 
buyers of these CDSs—AIG’s counterpar-
ties—collected significant payouts as benefi-
ciaries of the federally sponsored Troubled 
Asset Relief Program (TARP) bailout funds. 

These included Goldman Sachs ($13 billion), 
Société Générale ($12 billion), Deutsche Bank 
($11.9 billion), Barclays ($8.3 billion), Merrill 
Lynch ($6.8 billion), Bank of America ($5.2 
billion), UBS ($5 billion), and PNP Paribas 
($4.9 billion). 

Until AIG’s near demise, its insurance 
subsidiaries were hugely profitable. AIG’s 
problem, though, was that it had also made 
billions of dollars of losing bets selling CDSs. 

These CDSs enabled AIG to make leveraged 
bets it could not afford and would not have 
been able to undertake if it were simply sell-
ing insurance—the bulk of its business. 

Many of AIG’s swaps both protected and 
insured CDOs, whose values could not be rea-

sonably assessed or monitored. Companies 
track fluctuations in the value of individual 
assets, such as mortgages. But when batches 
of mortgages are sold en masse to a special 
interest entity, divided into tranches, and sold 
as CDOs, the fluctuating value of those mort-
gages cannot be accurately scrutinized or 
evaluated. 

The value of CDOs is determined by credit 
rating agencies, whose mathematical models 
for rating assets have been highly unreli-
able. When it came to these ratings, Buffett 
was on target when he warned: “Beware of 
geeks bearing formulas.” 

Many of AIG’s CDSs were bets on the creditworthiness of poorly rated CDOs that were backed by 
poorly underwritten subprime loans. 

When the real estate markets faltered, AIG’s bond rating was downgraded. These rating down-
grades in turn led to company write-downs and to collateral calls from the buyers of 

CDSs that AIG sold. 

Having suffered a series of devastating 
financial blows practically all at once, AIG 
lacked the liquid assets to post the required 
collateral and fell into a death spiral. At this 
point, AIG could only avoid bankruptcy if it received an immediate cash infusion. 

Lawmakers quickly allocated taxpayer funds to rescue AIG. They viewed AIG as too big 
and too integral a part of the economy to fail. AIG, of course, was not alone in writing the 

CDSs for CDOs whose values were based
On unreliable credit ratings. Investment banking giant Bear Stearns, the Monoline bond insurers, and others lost billions of dollars selling CDS contracts they could not cover.

**Absence of Regulatory Oversight**

The absence of regulatory control over derivatives is no accident. Throughout the 1990s, a powerful lobbying group, the International Swaps and Derivative Association (ISDA), persuaded the federal government to largely deregulate derivatives. Former U.S. Senator Phil Gramm of Texas and his wife, Wendy Gramm, were ISDA’s greatest champions.

In 1992 Ms. Gramm, then chairwoman of the Commodities Futures Exchange Commission, pushed the commission to adopt commodities trading regulations that severely limited federal oversight over derivatives. Notably, these regulations included a provision eliminating administrative rules restricting the trading of energy futures derivative contracts. This provision opened the door to Enron’s becoming a derivatives trading company and became known as the Enron exemption. The trading of these energy futures derivatives would wreck Enron, but not before it wreaked havoc on California’s electricity market and cost California customers billions of dollars.

Ms. Gramm was lavishly rewarded for helping Enron secure this exemption to become a virtually unregulated energy trading company. The company gave her a position on its board of directors, and during her brief tenure on the board in the mid-1990s, she received $915,000 in cash, $1.85 million in stocks and dividends, as much as $50,000 in annual salary, and $176,000 in attendance fees, according to Public Citizen, a nonprofit public interest watchdog group.

Like his wife, former Senator Gramm also fiercely opposed regulation of the financial services industry. In 1999, he sponsored legislation that repealed the Depression-era Glass-Steagall Act of 1933, which separated commercial and investment banking. The repeal of this legislation enabled commercial lenders to trade derivatives such as CDSs and to establish structured investment vehicles that bought those securities.

In late 2000, Senator Gramm and U.S. Senator Richard Lugar from Indiana cosponsored the Commodities Futures Modernization Act of 2000. More accurately, they quietly inserted this 262-page bill (written by the ISDA) into a $384 billion, 11,000-page omnibus budget bill, which Congress passed and President Bill Clinton signed in the waning days of his administration.

Given the circumstances, it is unlikely that many lawmakers or members of the Clinton administration reviewed this legislation or even read it. At the time, President Clinton was granting last-minute pardons, and the Clintons were preparing to move to their new home in Chappaqua, New York. Lawmakers and much of the country, meanwhile, were distracted by the disputed presidential election between Vice President Al Gore and Texas Governor George W. Bush, decided 5-4 by the Supreme Court two days before in *Bush v. Gore*.

The Commodity Futures Modernization Act ensured that CDSs would not be subject to federal regulation. Worse, it preempted state anti-bucket-shop laws. Many states passed these laws after the Panic of 1907 to outlaw illegal gambling on securities, which partly led to that economic calamity. Prior to these laws, bettors at storefront shops would drop their wagers on stocks into buckets. As a result, these gambling dens came to be called bucket shops.

New York as well as other states passed anti-bucket-shop laws to stop the trading of stocks in bucket shops. Had the Commodity Futures Modernization Act not become law, these anti-bucket-shop laws could have limited some damage caused by the speculative trading of CDSs.

Damages could have been reduced even more if the policymakers and lawmakers followed the advice and heeded the warning of Brooksley Born, chairwoman of the Commodities Futures Trading Commission during the Clinton administration. A voice in the wilderness in the last two years of the Clinton presidency, Born unsuccessfully sought authority—both within the Clinton administration and through Congress—to regulate derivative instruments. Prophetically, she warned that unregulated derivatives trading threatened markets and the economy. Her warning was ignored.

One way that injured parties are now addressing the CDS problem is litigation. The lawsuits that have been filed, all in their early stages, include securities class actions brought by investors in companies, like AIG, that sold CDSs. At the core of these actions are allegations that companies misrepresented the value of their CDSs and concealed material information about their contractual exposure. ERISA and derivative lawsuits that include similar allegations have also been filed.

Other litigants have filed breach-of-contract lawsuits for alleged failures to make required CDS payments. These actions center on whether (or when) a default, a collateral call, a margin call, or other triggering event occurred, and on which CDS sellers are liable when multiple CDSs were written to cover the same event. In addition, CDS sellers have brought lawsuits, alleging that they were wrongfully forced by buyers to prematurely pledge additional collateral even though their contracts should not have required them to do so. Some of these lawsuits could turn out to be particularly high-stakes contests.

CDSs also raise thorny issues that bankruptcy courts will be called on to address. For example, disputes are likely to arise between CDS holders and other bankruptcy claimants relating to whether (or when) a CDS entitles a claimant to jump ahead of certain bankruptcy creditors.

**Regulation Wars**

Former President Clinton deeply regrets that his administration failed to regulate derivatives. “I very much wish now that I had demanded that we put derivatives under the jurisdiction of the Securities and Exchange Commission and that transparency rules had been observed,” he told a reporter. “That I think is a legitimate criticism of what we didn’t do.” Expressing similar regrets, Eric Dinallo, the former New York state insurance commissioner and a leading advocate of the regulation of credit derivatives, observed that “[a] major cause of our current financial crisis is not the effectiveness of current regulation, but what we chose not to regulate.”

Not surprisingly, the Obama administration and Congress are facing strong pressure to regulate derivatives—and both branches are responding. As a prelude to new legislation, the Obama administration is drafting language to send to Congress as a model proposal, and Congress is holding hearings. Meanwhile, some states, like New York, are considering the enactment of their own legislation if federal legislation proves inadequate and does not preempt state legislation.

President Obama blamed the financial crisis on “a culture of irresponsibility,” and said his administration will propose to Congress new “rules of the road” to regulate derivative trading. Shortly after these remarks in June, Treasury Secretary Timothy Geithner gave a broad preview of what these rules will, and will not, include. He testified before Congress that the administration’s aim would be to enhance oversight over derivatives, increase transparency of these instruments and contracts, and reduce systemic risks. Toward those ends, he said, the administration will recommend imposing capital requirements for CDS sales, enhancing regulatory oversight, and requiring all “standardized” derivatives to be traded on regulated exchanges or clearinghouses.

Although some lawmakers want to ban naked swaps, the administration’s proposal apparently will not recommend this. Those who urge that naked swap trading should not be outlawed contend that these swaps increase market liquidity, making it cheaper for businesses to borrow money. The administra-
tion’s proposals also will not require “cus-
tomized,” one-of-a-kind derivatives (mainly CDs) to be traded on an exchange or through a clearinghouse.

Geithner thinks that it is impractical, or impossible, to require product-specific, indi-
vidual, negotiated contracts to be traded on an exchange or through a clearinghouse.43 But some lawmakers view this exemption for customized derivatives as dangerous.44 Senator Tom Harkin of Iowa has introduced legislation requiring all derivative instru-
m ents—including customized ones—to be traded on regulated exchanges. He fears that an exemption for customized instruments would be too easy to manipulate and would create a “loophole big enough to drive a truck through.”45 Given a choice, deriva-
tives’ traders will favor less-regulated, less-
transparent approaches, because customers most likely will pay far less for derivatives in a transparent market with open competition dictating prices.46

Big banks, which won the derivative reg-
ulation wars in the 1990s and then last year accepted hundreds of billions of dollars of tax-
 payer-funded TARP bailout funds, are lobby-
ing to substantially water down any new legislation.47 Indeed, they have proposed their own voluntary rules.48 Yet those favoring serious reform believe that these banks have taken a position that is shortsighted, if not irresponsible. As Yra Harris, an independent commodities trader who has fought for enhanced oversight will benefit everyone, including those in the financial community subject to close regulatory scrutiny. In the 1930s, regulatory reform curbed the worst abuses of the Roaring Twenties that F. Scott Fitzgerald deftly chronicled. It can do the same today.

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The Power of Knowledge.
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Sixty-four banks failed in the United States in the first seven months of 2009, compared to only 24 in all of 2008 and a mere three in 2007. Many more are expected to fail by the end of the year, as commercial real estate loan defaults increase and high unemployment hampers economic growth. This dramatic spike in bank failures also has significantly increased the probability that a business might be a counterparty to a failed bank in a variety of contractual relationships.1

Anticipating a bank failure can be a difficult prospect for counterparties. Telltale signs are rarely evident. Banks are obliged to maintain both capital adequacy and balance sheet solvency. However, those calculations are rarely simple, and sometimes they are not wholly transparent to outsiders. Complex banking regulations relating to capital adequacy further complicate the evaluation of a bank’s assets and liabilities. Additionally, the “supervisory” correspondence, examination reports, and warnings from a bank’s regulators are confidential.

Bank regulators usually work very hard to keep a troubled bank’s predicament quiet to prevent a run on the bank, preserve systemic economic confidence, and obtain the best price for the bank’s assets in any arranged deal. In some cases, regulators issue an order requiring the institution to take certain actions—usually to increase its capitalization over a specified time2—but determining the status of the institution’s compliance is still difficult. Often, the only advance signal is a securities filing from the institution itself that it cannot continue as a going concern, but this filing usually comes only days before serious regulatory action.

An official resolution is underway when...
the agency that chartered the bank issues a Failed Bank Letter to the FDIC, stating that the bank is failing or is in imminent danger of failing, and will be closed. This typically happens when a bank has become critically undercapitalized, insolvent, or unable to meet requests for deposit withdrawals. Failed Bank Letters are eventually posted on the Web site of the Federal Deposit Insurance Corporation (FDIC)\(^3\) but only after a failed bank has been closed, so they do not provide timely warning for the bank’s creditors.

Unfortunately for the counterparty in a bank transaction, some banks may be subject to special rules on their transactions long before any official resolution process commences. For example, capital inadequacy—which might occur passively through downward revaluations of investment assets in the bank’s portfolio—may limit a bank’s ability to lend. Alternatively, a regulator can impose interest rate limits or similar restrictions on a troubled bank’s permitted loan terms if the regulator decides that the bank’s interest rate practices or exposures are questionable.\(^4\)

Whether a bank is in an official or unofficial resolution stage, counterparties will have numerous questions about their rights and liabilities regarding the failing or failed bank. This is true for a variety of customary transactions in which these counterparties may be involved, including deposit accounts, secured loans, unsecured loans, syndicated loans, swaps and similar derivatives, and letters of credit. For counsel advising these parties, an understanding of how the FDIC\(^5\)—as overseer of U.S. insurance funds for depositary financial institutions—approaches bank failures is a necessary prerequisite to assessing how these failures may affect any particular transaction.

**The Role of the FDIC**

The FDIC’s process for resolving bank failures (and how it deals with bank counterparties) is driven by its primary goals of maintaining stability and public confidence in the U.S. banking system, and minimizing the government payout of monies from the FDIC insurance fund. In carrying out these goals, the FDIC serves several functions. First, it is one of several regulators responsible for banks and thrifts. Others include the Office of the Comptroller of the Currency, which is responsible for national banks; the Federal Reserve, which is responsible for both state member banks and holding companies; the Office of Thrift Supervision, which is responsible for thrift institutions; and various state agencies.\(^6\)

Second, as the insurer of deposit accounts, the FDIC controls risks to the Deposit Insurance Fund, which protects the depositors in FDIC-insured institutions. When a federally insured depository institution fails, and if no other resolution proves less costly, the FDIC pays out insured bank deposit accounts. Third, the FDIC acts as receiver, conservator, or liquidating agent for failing insured depository institutions—whether chartered as a national bank, state bank, or federal thrift—to promote their efficient and expeditious liquidation. In this capacity, the FDIC has broad power and authority to “resolve” the problems of the failing institution through asset sales or other techniques, or to put the institution into receivership and close it, or to combine a partial resolution with a receivership. In fact, regulators enjoy far more discretion in working out a troubled bank’s obligations than do parties to a corporate bankruptcy, as there are significant differences between corporate bankruptcy law and the insolvency laws for financial institutions—and the latter are actually excluded from Title 11 of the U.S. Code (governing business reorganizations).\(^7\)

Bank regulators have five basic options to fix, sell off, or liquidate all or part of a failed bank’s business: open bank assistance, management change, purchase and assumption transactions, receivership, and depositor payoff. These options are described, along with some commentary about the FDIC’s choices of methods, in the FDIC’s Resolutions Handbook.\(^8\) The handbook states that the FDIC’s official resolution process usually takes 90 to 120 days, but much of this process occurs in secret before the official closure—and typically without notice to most of the bank’s employees.

Once the FDIC gets the needed data about the failing bank, a team of FDIC resolution specialists will analyze the bank’s condition. Because it does not have enough time to assess every asset, the team generally estimates the value of the bank’s assets by using a statistical sampling procedure to populate valuation models. For each category of loans, the FDIC identifies a sample, reviewing selected loans to establish an estimated liquidation value based on discounted future cash flows and collection expenses. The team derives a loss factor for that category of loans and applies it to all the loans issued by the failed bank in that category.

The FDIC is required to use the type of resolution that is the least costly option calculated over time on a net present value basis. The cost to the FDIC can vary depending on a wide range of factors,\(^9\) including the premium paid by an acquirer, the likely losses on contingent claims, the estimated value of the assets and liabilities of the bank, the levels of insured and uninsured liabilities, any cross-guarantees available against the failed bank’s affiliates, and the cost of collecting on assets not transferred in purchase and assumption deals.

Any losses are borne first by equity investors (shareholders) and unsecured creditors. The FDIC and customers with uninsured deposits absorb the remaining losses, with the FDIC proportionately sharing all the amounts it collects with uninsured customers.

The FDIC can choose to leave a troubled bank open and pump assistance into it—the “open bank assistance” (OBA) option—which has not been used with any frequency since the savings and loan crisis in 1989. That was when the FDIC started comparing the cost of the OBA option with the sale of bank assets via competitive bidding, and found that selling assets usually costs less. Evolving policies also caused the FDIC to move away from leaving a troubled bank’s assets in the hands of its original management. For example, in 1987, the FDIC was first authorized to establish free-standing “bridge banks”\(^10\)—temporary banks created to service a failed bank’s assets prior to their sale. A bridge bank provides the FDIC with more time to find a permanent solution for resolving a significant collection of assets. As a result of this less expensive policy option, OBAs are no longer commonly used. But the OBA option is available when the financial system is perceived to be threatened by systemic risks, such as in late 2008 and early 2009 when the Troubled Asset Relief Program provided billions of dollars to banks deemed by the government to be “too big to fail.”\(^11\) From time to time the FDIC has used similar programs to prop up or deliberately overlook some of a troubled bank’s failings. These options include “net worth certificates,” which essentially constitute a temporary fiat that the troubled bank will be deemed to have more reserves than its examination verifies. Other programs include “income maintenance” and “regulatory forbearance,” in which a bank is acknowledged (at least privately by the regulators) to have defects in its balance sheet or practices but is permitted to continue to operate subject to certain conditions.\(^12\) Few of these methods, though, preserve the possible value of a troubled bank’s assets—or minimize the running losses—as quickly as a “purchase and assumption” asset sale transaction, so these older options are no longer favored.

Changing the management is an option not found in the FDIC’s official resolutions playbook, but the FDIC appears to use it with some frequency. As a regulated industry, banks always are subject to supervision for “safety and soundness” and to continuing vigilance over the qualifications, competency, and absence of conflicts of interest of a bank’s senior management and board of directors. The wide-ranging powers of a bank’s princi-
MCLE Test No. 185

The Los Angeles County Bar Association certifies that this activity has been approved for Minimum Continuing Legal Education credit by the State Bar of California in the amount of 1 hour.

1. Information about a bank’s risk of going into a receivership is easy to obtain.
   True.
   False.

2. The Federal Deposit Insurance Corporation (FDIC) is the only regulator responsible for banks and thrifts.
   True.
   False.

3. The FDIC has the same discretion in managing a bank receivership that a bankruptcy trustee has in managing a corporate bankruptcy.
   True.
   False.

4. The resolution method that is the most frequently used for failing banks today is:
   A. Open bank assistance.
   B. Regulatory forbearance.
   C. Purchase and assumption transactions.
   D. Depressor payoffs.

5. The most important factor that the FDIC must consider in choosing a resolution method for an insolvent bank is:
   A. The cost to the government.
   B. The speed of resolution.
   C. The effect on other banks.
   D. The effect on banking customers and the community.

6. When the FDIC is selling failed bank assets, it typically offers them only to a prequalified set of potential bidders.
   True.
   False.

7. Buyers of troubled bank assets usually can expect some negotiation and competition over the price but not the terms.
   True.
   False.

8. In a receivership, most classes of creditors will receive equal treatment.
   True.
   False.

9. A bank’s creditor may protect itself with a contract term that makes the bank’s receivership an event of default.
   True.
   False.

10. Bank receivers generally give creditors 90 days to file their claims against the bank or else lose their rights.
    True.
    False.

11. A bank receiver will apply conventional contract law to assess claims that contracts of a failed bank have been properly completed, approved, or modified.
    True.
    False.

12. Among classes of bank creditors, do insured depositors usually enjoy some preference or higher priority in a bank’s receivership?
    Yes.
    No.

13. Do uninsured depositors usually enjoy some preference or higher priority in a bank’s receivership?
    Yes.
    No.

14. Do borrowers with a secured loan usually enjoy some preference or higher priority in a bank’s receivership?
    Yes.
    No.

15. Do parties to a swap or forward contract usually enjoy some preference or higher priority in a bank’s receivership?
    Yes.
    No.

16. Does a bank’s landlord usually enjoy some preference or higher priority in a bank’s receivership?
    Yes.
    No.

17. Does a bank’s tenant usually enjoy some preference or higher priority in a bank’s receivership?
    Yes.
    No.

18. Does the holder of a bank’s uncollateralized letter of credit usually enjoy some preference or higher priority in a bank’s receivership?
    Yes.
    No.

19. The receivership of one lender in a multi-lender syndicated loan will always prevent the outstanding undisbursed balance of the loan from being funded to the borrower.
    True.
    False.

20. Like a bankruptcy trustee, bank receivers have some powers to undo recent, economically unfavorable transactions.
    True.
    False.

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ANSWERS

Mark your answers to the test by checking the appropriate boxes below. Each question has only one answer.

1.  
   □ True   □ False

2.  
   □ True   □ False

3.  
   □ True   □ False

4.  
   □ A □ B □ C □ D

5.  
   □ A □ B □ C □ D

6.  
   □ True   □ False

7.  
   □ True   □ False

8.  
   □ True   □ False

9.  
   □ True   □ False

10.  
    □ True   □ False

11.  
    □ True   □ False

12.  
    □ Yes   □ No

13.  
    □ Yes   □ No

14.  
    □ Yes   □ No

15.  
    □ Yes   □ No

16.  
    □ Yes   □ No

17.  
    □ Yes   □ No

18.  
    □ Yes   □ No

19.  
    □ True   □ False

20.  
    □ True   □ False
pal regulators to unilaterally remove a bank’s management are difficult to challenge.

Most of the large-scale bank merger-and-sale transactions accomplished at the beginning of the current wave of resolutions in 2008 apparently were instigated by regulators. News reports noted that even the management of some buying institutions may have determined that their jobs were threatened if they did not accept the rescue transactions that federal bank regulators were urgently suggesting. In their business dealings with banks, counterparts should be sensitive to the bank’s loss of flexibility and other changes in tone.

**Purchase and Assumption Transactions**

Purchase and assumption transactions currently are the FDIC’s most favored procedure for resolution. Under this procedure, the failed bank, or some of it, is sold to a healthy acquirer. The buyer assumes certain liabilities, particularly deposits, in return for assets and, usually, some federal assistance or risk protection. If the FDIC decides that a purchase and assumption transaction is the most cost-effective resolution, it will choose whether to sell the failed bank as a whole or in parts, what assets should be offered for sale, how to package them, whether loss sharing will be offered, and at what price the assets should be sold.

Operating under strict confidentiality prior to the bank closure, the FDIC markets the failing bank as broadly as possible to its list of approved potential acquirers. Either financial institutions or private investors seeking a new bank charter may be potential acquirers, but all acquirers must have adequate funds first and foremost. Typically, all bidders are invited to an informational meeting, sign confidentiality agreements, and are provided with an information package prepared by the FDIC’s resolution team. The deal terms usually focus on the treatment of the deposits and assets held by the failing bank.

Once a bidder completes its due diligence, it submits its proposal to the FDIC. Bids often must be submitted only a few days before the scheduled bank closing. The FDIC evaluates the bids to determine which one of them costs least and compares them to the FDIC’s estimated cost of liquidation. Many of the FDIC deals that are being transacted today are structured essentially as “as-is” deals, with negotiations allowed for price and perhaps also for downside loss protections but not for much else. This makes some sense in light of the large current and anticipated volume of resolution transactions facing the FDIC and its desire to assure lowest-cost outcomes by letting the market set the prices. This reduces the risk that the FDIC’s resolutions will be subject later to second guessing.

The FDIC submits a written request for approval of the negotiated purchase and assumption transaction to the FDIC Board of Directors. Following board approval, the FDIC notifies the acquirer (or acquirers, if assets of the failed bank are split up), all unsuccessful bidders, and the failing bank’s chartering agency; arranges for the acquirer to sign all needed legal documents; and coordinates the mechanics of the closing with the acquirer. After the FDIC closes the bank, typically on a Friday, the acquirer reopens the bank, often on the next business day. If the purchase and assumption agreement includes continuing FDIC assistance, such as loss sharing, then the FDIC monitors the assistance payments until the agreement expires, which may not be for several years.

If a failing bank resolution is not completed before there is a run on the bank or other liquidity crisis, the FDIC might not have time to complete a purchase and assumption transaction. In that case, the FDIC must use its other options such as failing the bank and transferring the insured deposits to another bank, or forming a bridge bank. To avoid those typically more expensive and therefore less desirable results, the FDIC prefers speed and relative secrecy in its purchase and assumption deals.

**Receivership**

If a purchase and assumption transaction is the FDIC’s carrot, its power to undo a failed bank’s deals in a receivership is its stick. Most bank receiverships are administered by the FDIC, which, as the insurer and protector of the bank’s depositor claimants, represents what often is a troubled bank’s largest creditor group.

The formal rules of a bank receivership proceed much like those for a corporate bankruptcy. Based on a finding that the institution is insolvent, the receiver takes over for the bank’s management. Many claimants must assert their claims with rapidity in a formal process or lose their rights. The receivership can move to stay litigation against the bank and undo fraudulent conveyances. Further, the regulator can clean up or reject many of the bank’s liabilities using other special legal powers that change or ignore the bank’s legal obligations. Also, the regulator can sell off, liquidate, or close pieces or the entirety of the bank’s business.

Options for Counterparties

When representing a counterparty contracting with a bank, a lawyer should consider how to protect the client in light of the power of bank regulators to reform or reject contracts and deals. If the bank fails, the client’s post-resolution fortunes may be influenced by factors such as whether the bank’s failure presents systemic risk to the financial markets, the quality of documentation, and the applicability of some protected classes of transaction.

Some types of transactions have a reasonable chance of riding through a resolution. In packaging assets for sale, regulators can use discretion to favor and preserve assets they think are essential to the marketplace. The types of institutions with which a counterparty deals may matter as well because regulators can, and do, play favorites to ensure that their resolutions and bank closings do not overly disrupt either geographic markets or market segments. The FDIC tries to keep some credit available to all creditworthy marketplaces.

In documenting deals with a bank to min-
Ever the most careful attorney faces several handicaps. A bank is not likely to be able to provide timely, reliable notification of its adverse or declining financial condition. So many of the covenants, certificates, or defaults typically used by lawyers for early warnings and remedies in cases involving a counterparty’s imminent failure do not work well in circumstances involving the failure of a failed bank—such as a debt, an existing lawsuit, or anticipated damages from a contract repudiation by the receiver—must take timely steps to keep the bank’s regulators officially aware of their rights. Bank receiverships include a bankruptcy-like “proof of claim” process that generally gives creditors a 90-day period for response. Failure to comply can result in a claim being rejected despite its merits. So creditors must be vigilant concerning notices of deadlines for their claims and should work with counsel familiar with troubled bank workouts.

Another risk arises in the event of incomplete documentation or approvals. Current receivership law codifies the special authority requirements set by the courts in D’Oench, Duhme & Company v. FDIC. The D’Oench, Duhme case held that a contract with a bank would not be honored in its later receivership if it was not in writing, signed by the right parties, formally approved by the bank at an appropriate board level, and correctly and continuously reflected in the bank’s official financial records. A lawyer documenting a transaction with a bank should insist that all important aspects of the deal are fully documented and approved by the bank. Side letters and similar informal devices risk being repudiated by the FDIC.

Survivability of Claims and Deals
The fortunes of a creditor’s specific claim often depend on the nature and priority of the class of its claim: depositors, borrowers, trade creditors, those buying or leasing real estate, or letter-of-credit holders. Deposit accounts are a favored class of liability, provided that the accounts in question are federally insured. FDIC coverage may be affected simply by the balance on deposit in the account. Many business accounts (such as cash management, impound, or lockbox accounts, through which the essential daily cash flow of a business moves) are likely to exceed this limit. Therefore, businesses should carefully consider the effects of a freeze of, or partial loss from, these essential accounts, and should also give serious consideration to the stability of the bank. One indication that a bank may be troubled is if it offers unusually high interest rates, because institutions trying to increase liquidity sometimes offer high rates to attract deposits. Deposit accounts that are not fully federally insured likely will experience losses or delays if they are not quickly transferred in a resolution to a new, solvent bank.

Another type of contract to which the FDIC as receiver may show relative deference is a loan secured by legitimate collateral. A nondefaulted secured real estate loan, for example, with an adequate loan-to-value ratio and proper documentation, is a valuable asset to a bank. Even if moderately diminished in value, it may have a strong chance of being packaged into an asset sale and surviving with a new, stable lender. Also, regulators are somewhat limited in their ability to abrogate or change vested property rights. The FDIC has stated that it usually will not seek to reject properly perfected and documented security agreements (including real estate mortgages). However, the outer limits of that protection are not well defined. Regulatory laws also provide limited protection for some kinds of specific derivative, option, swap, and forward contracts defined as “qualified financial contracts,” and for some kinds of “true sale” asset-structuring...
transactions for securitization. QFCs generally are contracts with sophisticated parties and are often executed at high speed and in large denominations. Their aim is to serve specific goals for financial risk management, such as foreign currency exchange exposure, and are thought to be necessary to keep capital markets working well.

Counterparties that have ongoing unsecured deals with a bank—such as unfunded loan commitments, agent bank responsibilities, real estate leases, or servicing contracts—are less protected. These counterparties should evaluate the likely attractiveness that their deal has to the bank and its successors in a potential resolution. The FDIC may seek to take on only favorable contracts or may reform contracts by accepting only the “good parts.” For example, the FDIC might continue to collect on amounts due under a partially funded construction loan but repudiate the duty to fund any future advances.

Other common types of unsecured open contracts with a bank include a real estate lease in which the bank is either a tenant or a landlord or an unfinished sale of real property by a bank turned insolvent. As in corporate bankruptcy, in a bank receivership the unfinished contracts may be reevaluated by the receiver and accepted, rejected (“repudiated”), transferred in a sale, or partially assumed and partially rejected. Generally, if the receiver repudiates, a thwarted buyer in possession, or a thwarted tenant in possession with an unexpired term, may choose either to remain in possession or treat the arrangements as terminated. Like other contract obligations, careful and timely response to the receiver’s notices and filing of a proof of claim may be important to preserve a creditor’s rights and any possible reimbursement.

Multiple lender arrangements also may provide some safety. The receivership of one member of a syndicated loan’s lender group may not be highly consequential to the borrower or the other lenders. While that lender’s receiver probably will not fund future advances under the loan—especially on a construction loan—the typical syndicated deal has provisions for lender replacement, so long as the replacement lender satisfies certain eligibility requirements (or other lenders in the group can make up the share). The failed lender that does not advance will become a defaulting lender and likely will lose its voting rights and its right to distributions.

A deal that was first transacted with a lender and then sold, such as a securitization transaction, is even less likely to be affected by a receivership of the originating lender. If the originating lender has retained loan servicing rights, those rights may be transferred with the loan or to a new servicer either by FDIC action or, if the FDIC repudiates the servicing contract, by the new owner or trustee of the relevant special purpose entity.

Letters of credit, often considered a rock-solid commitment in business transactions, do not necessarily fare well in bank receiverships. Letters of credit constitute a bank’s forward commitment to pay an amount on demand to a beneficiary, based on the credit of another (the “account party”). However, unlike the FDIC’s assurance regarding perfected collateral, the FDIC does not do the same for letters of credit. The FDIC states that “payment will be made to the extent of available collateral, up to...the outstanding principal amount...of the secured obligations, together with interest at the contract rate” and certain contractual expenses.

But an unsecured or undersecured letter of credit, with a credit-impaired account party, is at risk of repudiation, because the FDIC is likely to view it as akin to an unfunded loan commitment to a shaky borrower. That is little comfort to the letter-of-credit beneficiary. However, the apparent rationale for this result is that the beneficiary accepted the letter of credit based on the creditworthiness of the issuing bank and thus took the risk of having erred in that assessment. Counterparties relying on letters of credit may...
want to reexamine the stability and credit risk presented by the banks that issued them.

No magic bullet will keep a deal with a bank facing regulatory resolution or receiver-ship from being terminated or changed. The legal processes for resolution are complex and discretionary. However, counterparties still can exercise vigilance and take some steps to recognize and protect against risks in their deal structuring with banks.

1 Other classes of financial institutions, including thrifts (savings and loan associations) and credit unions, are subject to most of the same, or in some cases similar, laws as banks.


9 Id., at 8, 13-15.


11 FDIC RESOLUTIONS HANDBOOK, supra note 8, at 57-65.


13 The purchase and assumption transaction creates some interesting asset purchase opportunities for institutions and investors. Like any regulated government bidding process, careful attention to the rules (including the time requirements for filings and other actions) and the advice of experienced counsel with regulated assets expertise are essential. Qualifying as a bidder, at the right time and place, and navigating through the precise offer that is being made require agility.

14 The CEO of a healthy bank recently described his experience of successfully bidding in a bank asset sale. In the span of a few days, the buyer indicated interest, assembled a quick bid, and rapidly conducted its diligence, with the FDIC on site—and without the knowledge of the employees of the troubled bank. “We finished up on a Thursday and had to provide a bid the following Tuesday. The next day (Wednesday) [the FDIC] asked for some clarification...Thursday...they notified us that our bid was accepted...Then it happened that Friday at 4 p.m. They went in and took over the bank and we followed them.” M. Padilla, Profiting from an Irvine Bank Failure, ORANGE COUNTY REGISTER, July 4, 2009, available at http://mortgage.freedomblogging.com/20090707/04/profiting-from-an-irvine-bank-failure/13163/.


17 The receivership process defined in 12 U.S.C. §1821 is notably without some of the input and voting mechanisms accorded to creditors in a corporate bankruptcy under Title 11 U.S.C.


19 12 U.S.C. §1821(d), (e).


23 FDIC RESOLUTIONS HANDBOOK, supra note 8, at 41-46.


31 See 12 U.S.C. §1821(e)(4) (bank as tenant), (e)(5) (bank as landlord), and (e)(6) (bank as seller of real property).


33 See O’Connor & Clark, Securitized Commercial Mortgage Loans, CALIFORNIA REAL ESTATE FINANCE PRACTICE ch. 10 (CEB 2006-09).


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According to Thomas Friedman, a New York Times columnist, “There are two superpowers in the world today. There’s the United States and there’s Moody’s Bond Rating Service.” As if to prove this point, claims against rating agencies arising from their credit rating activities have historically been unsuccessful against the defense that credit ratings are opinions protected under the First Amendment. Under the standard articulated in New York Times v. Sullivan, opinions cannot serve as a basis for liability unless the plaintiffs can establish actual malice by the credit rating agencies. These agencies have also won some early cases on the basis of the journalist’s privilege and related shield laws, which provide a First Amendment-based defense to discovery requests seeking the basis for credit ratings. Nevertheless, in June 2009, the California Public Employees Retirement System filed suit in San Francisco against Moody’s, Fitch, and Standard & Poor’s for negligent misrepresentation in their ratings of $1.3 billion in “structured investment vehicles.”

There is some hope for the Calpers lawsuit. An emerging trend in the law invalidates the credit rating agencies’ First Amendment defenses and related journalist shield law defenses. The leading cases in this line suggest that four key elements need to be present to successfully assert rating agency liability in cases not involving misrepresentation or outright fraud:

- The rating agencies are paid for their credit ratings by the issuer or underwriter of the securities.
- The ratings are provided to a limited group of recipients to whom the securities are marketed and sold, rather than to a larger public audience.
- The rating agencies actively participate in the structuring of the securities transactions for which the ratings are provided.
- Taken together, these circumstances show that either privity or “near privity” exists between the rating agencies and the limited group of plaintiffs to whom the securities were marketed and sold.

The role of rating agencies in the structuring, marketing, sale, and compensation schemes of many of the financial products and derivatives that were a key factor in last year’s financial collapse went far beyond the bounds of traditionally protected journalistic analysis or opinion making. Rather, the rating agencies were active participants in the structuring of toxic mortgage-based debt instruments, from which they profited handsomely. Their complicity in these debt security arrangements may be enough to overcome existing rating agency protections, a possibility that is finding increasing favor in govern-

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ment and the judiciary, unless another crisis-driven government bailout provides a “get out of jail free” card in their favor.

**Collateralized Debt Obligation**

There is no doubt that the so-called toxic assets held by financial institutions have played a significant role in the financial and credit crisis still affecting the country. These toxic assets consist in large part of collateralized debt obligations (CDOs). A CDO typically is built from traditional debt and securities instruments that are packaged together and sold to investors who, in return for periodic payments of interest, bear the losses that occur if instruments in the portfolio default. Many of the CDOs upon which the current credit and financial crisis turns contained large quantities of subprime and so-called Alt-A residential loans. (Alt-A loans were made to borrowers whose credit quality was in between prime and subprime.) These residential mortgage CDOs were also known as residential mortgage-backed securities, or subprime RMBS.

In forming a CDO, a sponsor—usually an investment bank—would create a trust to hold the CDO’s assets, and the investment bank would issue securities representing interests in the CDO asset pool. In a subprime RMBS CDO pool, residential mortgages would make up the bulk of the underlying assets, but the trust might also hold other assets either to create a credit enhancement (for example, a holding of bonds could provide some income stability to a CDO, the assets of which were made of variable rate loans) or to “park” cash received from early payoffs or other unexpected events. The CDO trust would then obtain interest and principal payments from the underlying mortgage obligors, which it would use to make interest and principal payments to the CDO investors. The trust would be structured to provide differing levels of credit enhancement to the securities issued in various CDO tranches. Credit enhancement would be provided through different mechanisms, such as subordination of lower tranches to higher tranches, overcollateralization, excess spread, bond insurance, and credit default swaps (CDS).

The underlying assets of a subprime RMBS CDO often were changed during the life of the CDO. For this task, the investment bank sponsor engaged a collateral or asset management firm that was charged with purchasing the securities that formed the substance of the CDO. The collateral manager could sell bonds or other portfolio enhancements and purchase other ones, all in the name of complying with the CDO trust agreement restrictions on holdings and the rating agencies’ requirements necessary to maintain the specific ratings given to the various CDO tranches. Through this process, the rating agencies maintained an ongoing involvement in the CDO, creating an interface with the collateral manager to ensure regular asset composition compliance.

In fact, the collateral manager also typically was required to purchase a significant proportion of synthetic CDS contracts—a hedge against defaults in the underlying mortgage pools—from the investment bank sponsor, in which the investment bank would be the swap counterparty. In other words, the CDO was required to “sell protection” to the investment bank, which provided a “premium” in return to the CDO, with respect to a reference basket of securities. The investment bank was entitled to choose the securities that were in the synthetic reference basket and could change the composition, without notice to or control by the collateral manager or others.

The rating agencies played an integral and ongoing role in this process, because the collateral eligibility criteria and the purchase or sale of CDS protection were designed to ensure that the rating agencies would be able to assign specific ratings to the various CDO tranches offered for sale—from AAA senior notes in the top tranche, to BB notes in the mezzanine tranches, all the way down to the unrated equity tranche at the bottom. The credit rating for each rated tranche was supposed to reflect the rating agency’s informed assessment of the creditworthiness of the securities issued from the tranche, based in part on the likelihood that the CDO issuer would default on its obligations to make interest and principal payments in full and on time. In fact, rather than independently evaluate a CDO investment after the fact, the rating agencies worked directly with the investment bank sponsor to produce the rating the sponsor wanted in order to better sell the CDOs to investors.

In particular, the collateral manager was supposed to apply what are commonly called collateral quality tests to assess whether the debt securities forming the vast bulk of the assets for the CDOs met the collateral eligibility criteria. All these tests and criteria were linked to rating agency tests, such as Moody’s Asset Correlation Test, Moody’s Weighted Average Rating Factor Test, Moody’s Minimum Weighted Average Recovery Test, the Weighted Average Spread Test, the Weighted Average Coupon Test, the Weighted Average Life Test, the Standard & Poor’s Minimum Recovery Rate Test, and the Fitch Weighted Average Factor Test. Subprime RMBS CDOs offering circulars and prospectuses typically included default probability assessments that, based upon their tests and linked to their corresponding ratings, were intended to meet investment guidelines and risk tolerances for institutional purchasers of the securities. These ratings were not vague, unspecified opinions but instead were touted as scientifically and empirically based and objective—with AAA ratings for the top tranche of super-senior notes supposedly corresponding to a very low risk of default.

Not only were the rating agencies complicit in structuring CDOs to achieve desired ratings, but the structure of the transaction assured that the rating agencies were paid for their services from the transaction itself, not from an independent fee or subscription. The CDO’s trust indenture agreement almost invariably contained so-called waterfall provisions that determined the priority of interest and principal payments. Simply put, the waterfall provisions described how the cash flow from a CDO was distributed to the tranches. A typical priority of payments schedule, or waterfall, worked together with ongoing rating agency coverage tests to ensure that senior tranche debt holders would be paid even if equity and lower tranches received nothing. For example, in a typical waterfall arrangement, the CDO trust used interest (and principal) payments from the underlying assets to pay first the fees and expenses of the CDO, including trustee, custodian, and paying agent fees, and the fees of the rating agencies; second, the net periodic coupon payment owed to any swap counterparty; third, the periodic asset manager fees; and finally, interest on senior tranches. Lower tranches were only paid if the foregoing payments were already satisfied. Equity received no payments until all tranches above it and related administrative costs (and rating agency fees) had been paid.

In creating this multi-tiered payment structure, the investment banks made sure that the rating agencies also would be paid before nearly everyone else. The rating agencies also enjoyed a top-priority position to recover their fees for rating the various tranches and the RMBS supporting those tranches in the interest proceeds waterfall provisions of the trust indentures for the trusts that held the underlying assets. Moreover, the rating agencies had a critical, ongoing role in the pricing of the various tranches and in determining rating-related events of default that triggered the waterfall priorities, at the top of which sat the collateral managers and rating agencies. Accordingly, in a typical subprime RMBS CDO, the interest and principal payment priorities for purpose of the waterfall provisions of the debt instruments were specifically tied to credit default tests that were linked to the ratings provided by the rating agencies. They used quantitative cash flow models that analyzed, under various stress scenarios, the amount of principal and interest payments...
expected to be generated from the loan pool each month over the life of the RMBS tranche securities. The output of this model was then compared against the priority of payments (the waterfall) to the RMBS tranches specified in the CDO’s trust documents.

Thus, far from providing a generic opinion of creditworthiness to a broad-based audience, the rating agencies were intricately linked to the structuring and payment provisions of the assets they rated, did so specifically for the benefit of targeted investors (CDOs were generally marketed in private placements to qualified institutional buyers under Rule 144A—Private Resales of Securities to Institutions—promulgated under the 1933 Securities Act10), and were directly compensated for this effort.

That these credit ratings were critical to the spread of CDOs in the financial markets is undeniable. Investors use credit ratings as a proxy for their own credit review and thus to support the level of credit risk they are willing to undertake with respect to particular debt securities. Fiduciary investors (such as pension funds, trustees, and insurance companies) typically may only acquire “investment grade” assets, primarily as determined by credit ratings. Assets that are below investment grade—speculative or junk bonds—are supposed to be excluded from the fiduciary investor’s pool of appropriate potential investments. Higher-quality ratings directly affected the pricing and marketability of the subprime RMBS CDOs offered for sale. Through the financial alchemy of CDS contracts (which hedged the risk of underlying defaults) and associated higher-quality ratings, pools of low-quality residential mortgages could be marketed as high-grade investments.

As a result, investors that would not buy individual subprime mortgages bought subprime RMBS aggregated into CDOs that sported high-quality ratings from the rating agencies. Subprime RMBS CDOs came to be held by pension funds, school districts, charitable organizations, municipal treasuries, and a vast number of other public and private trust fund investors that could ill afford the losses that were to come.

However, even though both purchasers and issuers of RMBS CDOs have suffered billions of dollars of losses resulting from the acquisition of interests in securities that now appear to have been wrongly labeled as investment grade by rating agencies, these purchasers and issuers typically have not sued the rating agencies. These investors are likely daunted by the legal precedents that protect rating agencies.

**Rating Agency Defenses**

Several recent cases, however, have been decided against credit rating agencies under circumstances that appear to coincide in critical respects with the involvement of the agencies in the structuring of subprime RMBS CDOs. One of these cases—*In re Fitch, Inc.*11—is particularly instructive. A bank purchased various CDOs structured by one of its brokers. The banking regulators concluded that the CDOs were not investment grade and compelled the bank to sell them. The broker refused to accept the return of the “a level of involvement with the client’s transactions that is not typical of the relationship between a journalist and the activities upon which the journalist reports.”15

In *LaSalle National Bank v. Duff & Phelps Credit Rating Company,*16 another New York case rejecting the rating agency’s First Amendment defense, the court denied the rating agency’s motion to dismiss claims based on its allegedly too-favor-
that third party, thereby showing an understanding of that party’s reliance on the professional’s work.19 The Duff & Phelps court noted that although the Credit Alliance test initially applied only to accountants, it has subsequently been applied to other professionals—including attorneys, real estate appraisers, architects, and realtors. The court saw no reason why it should not also apply the privity requirement to a securities rating company.20

Finally, in Commercial Financial Services, Inc. v. Arthur Andersen LLP, the court held that the First Amendment does not protect professional’s work.19 The standing of that party’s reliance on the professional’s work.20

The Commercial Financial court noted a “crucial distinction” between the suit before it and Jefferson County School District No. R-1 v. Moody’s Investor’s Services,22 which dismissed claims for tortious interference, injurious falsehood, and antitrust violations because Moody’s credit ratings are “protected expressions of opinion.” In Jefferson County, Moody’s published its opinion for the benefit of subscribers and new services. “It had not been asked to rate the bonds [by the school district issuing them].”23 By contrast, in Commercial Financial the professional role of the rating agencies went “beyond a relationship between a journalist and subject, and [was] more analogous to that of a client and the client’s certified public accountant.”24 In such a case, the First Amendment does not shield the rating agencies from potential liability.

The Commercial Financial court also held that the facts of that case satisfied Section 552 of the Restatement (Second) of Torts, titled Information Negligently Supplied for the Guidance of Others,25 which supported its analysis that liability may be imposed on a professional information provider that negligently furnishes information for a fee that it knows will be provided to and relied upon by a limited group of persons. Because the ratings at issue in Commercial Financial were done at the request of the plaintiff, for a fee, and were intended to be provided to the plaintiff, who could be expected to rely upon them, the Commercial Financial court held that Section 552 applied to the credit rating agency.26

Based upon the reasoning and analyses underlying the holdings in In re Fitch, Inc., Duff & Phelps Credit Rating Company, and Commercial Financial, the role of rating agencies in the structuring, marketing, and sale of subprime RMBS CDOs went far beyond the parameters of protected speech and analytical opinion established under First Amendment–based journalist’s privilege or related statutory shield laws. In view of their central role in the structuring of subprime RMBS CDOs, and their dynamic and ongoing role in re-rating CDO tranches over time after their initial issuance, a strong argument can be made that the rating agencies were providing professional services to issuers and investment banks, with a clear set of potential investors in mind—typically qualified institutional buyers in private (nonpublic) securities Rule 144A offerings—and were not engaged in any meaningful sense or degree in news gathering, news analysis, or other journalistic activities.

In summary, the structure of typical subprime RMBS CDOs, and related CDS protection, provides a strong basis for liability against the rating agencies involved in these transactions, for negligent misrepresentation, because 1) they were paid fees to structure the transactions and had a direct financial incentive to be actively involved, in an ongoing, dynamic manner, in the management of the ratings process (i.e., the collateral manager could replace securities with higher-rated securities as necessary to maintain the overall rating of particular tranches, 2) the ratings of the subprime RMBS CDOs were provided to a limited group of recipients to whom the securities were marketed and sold, rather than to the larger public, at least with respect to the original purchases in the private placements (versus purchases made in the secondary market), and with respect to the original sellers of CDS protection in the initial private placements, 3) the rating agencies had an active, central, interactive, and ongoing role in the structuring and rating of the subprime RMBS CDOs and their respective tranches, and 4) taken together, these circumstances ought to be sufficient to show that either privity or near privity existed between the rating agencies, on the one hand, and the limited group of plaintiffs to whom the securities were marketed and sold, on the other.27

Negligence or Wrongful Acts

Once the four elements are shown to be satisfied, it is still necessary to show that the rating agencies acted negligently or wrongfully. In this regard, the question is whether the rating agencies knew or should have known that their assigned ratings were less reliable than the rating agencies made them appear, knowing the reliance placed on the ratings. When rating subprime RMBS CDOs, the rating agencies typically used indenture guide-
lines as a template to run worst-case scenarios based on the underlying assets. The rating agencies would apply their proprietary computer models to the types of collateral pools permissible under the indenture guidelines, placing the most emphasis on the weakest pools. Next they would compare the computer model results against the capital structure of the CDOs to assess whether the level of subordination, overcollateralization, and excess spread available to each rated tranche provides the necessary amount of “credit enhancement” to support a particular rating.

This sounds impressive, but the sad truth is that the rating agencies used computer models that were inadequate, were based upon inadequate information and faulty default assumptions, and were operated and analyzed by rating analysts who did not understand what they were doing and what the data revealed. In particular, the rating agencies and the issuers and underwriters that paid their fees relied almost universally on Monte Carlo simulation-based approaches to assessing default probabilities, predicated on a correlation model called the Gaussian copula formula, which was developed by former J.P. Morgan quantitative analyst David X. Li. Monte Carlo simulation-based approaches to assessing default probabilities rely on several key assumptions regarding default frequencies, recovery rates, and correlations. The primary rating agencies used proprietary software tools to conduct these complex Monte Carlo simulations. During the time leading up to the beginning of the financial crisis in 2007 and 2008, Standard & Poor’s used CDO Evaluator 3.3, Moody’s used CDOROM, and Fitch used VECTOR 3.0.

These computer models are only as reliable as the assumptions on which they are predicated and the people who operate and interpret the models. The assumptions were outdated. Assessing future default risk in subprime mortgage loans based upon past performance was not and could not be a reliable predictor when the fundamental underwriting criteria used in the past was not being used in connection with subprime RMBS that formed the core of the CDO tranches actually being rated. But the rating agencies evidently turned a blind eye to this problem, relying on the Gaussian copula formula to provide supposed added security to their probabilistic default assessments.

Thus, to assess the myriad variables and the range of different probabilistic outcomes arising from multiple ever-changing variables, the rating agencies relied on the Gaussian copula formulation to simplify and quantify RMBS default probabilities based upon complex and exceedingly variable correlations.28 (In statistics, a copula is used to couple the
behavior of two or more variables.) The Gaussian copula soon became such a universally accepted part of the world’s financial vocabulary that brokers started quoting prices for bond tranches based on their correlations. “Correlation trading has spread through the psyche of the financial markets like a highly infectious thought virus,” wrote derivatives guru Janet Tavakoli in 2006.29

But this Gaussian copula formula was simplistic and flawed. The damage was foreseeable and foreseen. In 1998, before Li had even invented his copula function, Paul Wilmott wrote that “the correlations between financial quantities are notoriously unstable.”30 Yet the rating agencies in rating subprime RMBS CDOs relied heavily on this copula correlation model that they did not really understand, even though they claimed that their ratings were based upon objective, thorough, and comprehensive analyses.

Finally, in addition to turning a blind eye to the increasingly lax underwriting standards used by loan originators and to the overly optimistic and reductionist formula used to quantify default risk, the rating agencies also mistakenly relied upon CDS to “insure” tranches that they were rating in order to buttress the ratings assigned to those tranches. A CDS typically acts—or rather, is supposed to act—like an insurance contract that protects the protection purchaser from the decline in value or other trigger event in a referenced entity or security in relation to which the CDS provides credit default insurance. In the case of subprime RMBS CDOs, “insurance” often was provided against default rates exceeding the predicted range for the asset type supporting a particular investment grade by the rating agencies for particular CDO tranches.

The key problem with the use of CDS to support the creditworthiness of particular tranches of subprime RMBS CDOs—a problem that should have been obvious to issuers, investors, and rating agencies alike—is that CDS contracts were freely tradable, usually without notice to CDO investors, and it was almost always difficult, if not impossible on an ongoing basis, to determine who the CDS counterparty was at any particular time and whether and to what extent that CDS counterparty was sufficiently solvent, creditworthy, and ready to fulfill its insurance obligations in an event of default. In fact, the CDS became a financial product with a life of its own, and CDOs were often linked with synthetic credit default swaps and complex hedging structures that in many cases were themselves linked to yet other CDOs imbedded with credit default swaps and hedging structures whose values and risk levels were not and could not be assessed accurately.

This history should provide more than
enough to overcome the traditional defenses of ratings agencies and expose them to liability. However, given the continuing central role that ratings agencies play in our financial and credit markets, it remains to be seen whether Congress, the Executive Branch, or the judiciary will be willing to address the massive liability that could face the rating agencies as a result of their complicity in the financial crisis.


5 Moody’s has been a stand-alone public company since 2000, when it was spun off from Dun & Bradstreet.

6 Fitch is owned by Fimalac, S.A., in France, which is controlled by Group Marc de Lachairière.


8 A CDO can hold different types of loans, emerging market debt, sovereign debt, high-yield corporate bonds, distressed securities (also junk bonds), asset backed securities, commercial mortgage backed securities, and commercial and industrial loans. By means of credit default swaps and other vehicles, access to these assets also can be achieved synthetically.

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10 In re Fitch, Inc., 330 F. 3d 104 (2d Cir. 2003). See infra notes 13-14 and accompanying text.

11 In re Fitch, Inc., 330 F. 3d 104 (2d Cir. 2003) (communications between rating agency and arranger “reveal a level of involvement with the client’s transactions that is not typical of the relationship between a journalist and the activities upon which the journalist reports”) and compare, e.g., In re Fitch, Inc., 330 F. 3d 104, 110-11 (2d Cir. 2003) (communications between rating agency and arranger “reveal a level of involvement with the client’s transactions that is not typical of the relationship between a journalist and the activities upon which the journalist reports”) with Compuware Corp. v. Moody’s Investors Servs., Inc., 222 F.R.D. 124, 131 (E.D. Mich. June 10, 2004); Cf. Compuware Corp. v. Moody’s Investors Servs., 324 F. Supp. 2d 860, 862, and 904 n.7 (E.D. Mich. 2004).


15 (quoting Paul Wilmott).
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There’s No Role for Media Critics in Copyright Infringement Cases

Media critics may overlook the fact that it is perfectly legal under the Copyright Act for an author to be inspired by a prior work. The Second Circuit may have best explained why media critics are not the arbiters of whether or not one work is “substantially similar” to, and thereby infringes, a previously existing work:

The “substantial similarity” that supports an inference of copying sufficient to establish infringement is not a concept familiar to the public at large. It is a term to be used in a courtroom to strike a delicate balance between the protection to which authors are entitled under an act of Congress and the freedom that exists for all others to create their works outside the area protected against infringement....

Media critics may overlook the fact that it is perfectly legal under the Copyright Act for an author to be inspired by a prior work. Such inspiration does not constitute “literary larceny.”

TRY THIS TEST: Search the Web for movie reviews in which the reviewer declares that a film is a “rip-off” of a prior work. Just type in the search terms “rip-off” and “movie review,” and let the immeasurable hits fill the computer screen.

One review you might find states that the 2009 Matthew McConaughey movie Ghosts of Girlfriends Past is a “rip-off” of Charles Dickens’s A Christmas Carol. Another reviewer contends that Beyoncé’s recent movie Obsessed is a “rip-off of Fatal Attraction.”

One reviewer who appears to have really enjoyed the 1979 movie Alien exclaims that Pitch Black, The Abyss, and The Cave each is a “rip-off” of the film. Still another writer noted that the original Terminator “doesn’t pretend to be anything more than a Road Warrior and Blade Runner rip-off on a quarter of the budget.”

Certainly, people are entitled to their own opinions. However, these sorts of entertainment program reviews are finding their way into a place where they do not belong—the courtroom in federal copyright infringement cases.

In one such case, Survivor Productions LLC v. Fox Broadcasting Company,1 the plaintiff complained that the television series Boot Camp infringed the copyright in the popular Survivor series. The plaintiff attached to its complaint articles that described Boot Camp as “a ripoff of Survivor.” In another case, RDF Media Ltd. v. Fox Broadcasting Company,2 the producer of the Wife Swap television series alleged that the television series Trading Spouses infringed the copyright in Wife Swap. The complaint attached quotations from “industry commentators” who declared that Trading Spouses was a “rip off” of Wife Swap. More recently, a plaintiff alleged that the 2007 motion picture Disturbia infringed the 1934 film Rear Window. The complaint set forth at least 46 alleged media quotes and attached 35 press clippings filled from media critics offering that opinion. One critic exclaimed, “They’re blatantly ripping off Rear Window! The bastards!”

Such articles by media critics have no place in copyright infringement actions. The few federal courts that have considered the propriety of introducing such “evidence” in copyright cases have found these articles to be entirely without relevance. The Survivor Productions court granted the defendants’ motion to strike the media quotations and exhibits from the complaint on the grounds that they were immaterial, impertinent, redundant, and scandalous within the meaning of Rule 12(f) of the Federal Rules of Civil Procedure. The court found that the articles “amount to nothing more than a post-hoc analysis of similarities between the programs by news reporters, unguided by the legal standards that govern the comparison of the two works under copyright law.”3 As such, the court stated that the publications had “no possible bearing on the controversy between the parties.”

Employing the same reasoning, the RDF Media court struck the media allegations and exhibits from the complaint, holding that such evidence is “legally irrelevant” to the issue of whether or not two works are substantially similar within the meaning of the Copyright Act.

BY LEE S. BRENNER

Lee S. Brenner is a partner at the law firm White O’Connor Fink & Brenner LLP. His practice includes all forms of entertainment law, with an emphasis on litigating copyright and idea submission claims.

3 Survivor Prods., 2001 WL 35829267 at *3.
6 Survivor Prods., 2001 WL 35829267 at *3.
ON FRIDAY, OCTOBER 30, the Business and Corporations Law Section will host its 42nd Annual Securities Regulation Seminar, during which top Securities and Exchange Commission officials, representatives of other regulatory agencies, and leading private practitioners will present a comprehensive review of current events and developments in the securities field. This seminar will include an overview of judicial, regulatory, and enforcement developments, as well as recent trends in the public and private offerings of securities, mergers and acquisitions, and other matters of interest to the securities bar. The seminar will take place at the Millennium Biltmore Hotel, 506 South Grand Avenue, Downtown. On-site registration will begin at 8 A.M., with the program continuing from 8:30 A.M. to 5 P.M. The registration code number is 010470. The prices below include the meals.

- $295—Early registration for all by September 11
- $350—CLE+PLUS members
- $375—Business and Corporations Law Section members
- $395—all others
- $475—all at-the-door registrants

7 CLE hours, including 1 hour of ethics

42nd Annual Securities Regulation Seminar

TAP Jury Selection Workshop

ON MONDAY, OCTOBER 12, the Trial Advocacy Project and the Litigation Section will host a course providing introductory and advanced level instruction on jury selection for civil and criminal cases. The first part of the program is a lecture with questions and answers covering peremptory challenges, making and responding to challenges for cause, unconstitutional use of peremptory challenges, processing prospective juror information, judicial and attorney voir dire, and selecting alternate jurors. The second part is a workshop in which participants practice voir dire, make and respond to challenges for cause, exercise peremptory challenges, and accept the panel. Participants receive constructive feedback on their performance. The program will take place at the Los Angeles County Bar Association, 1055 West 7th Street, 27th floor, Downtown. Parking is available at that address for $10 with validation as well as various lots nearby for less. The registration code number is 010319. This program fills quickly. On-site registration, if available, will begin at 1 P.M., with the program continuing from 1:30 to 5:30. The prices below include the meal.

- $250—LACBA members
- $350—all others

3.75 CLE hours

Minor’s Counsel Training Program

ON FRIDAY AND SATURDAY, OCTOBER 2 and 3, the Los Angeles County Bar Association will provide the education and training required of minor’s counsel. Effective January 1, 2009, before being appointed as counsel for a child in a family law proceeding, counsel must have completed at least 12 hours of applicable education and training. This program will provide an overview of the law, the perspective from the bench, practice pointers from frequently appointed minor’s counsel, and input and guidance from mental health professionals experienced with children caught in the middle of high-conflict cases. This program will also include a discussion of the due process, constitutional, and evidentiary issues that minor’s counsel face. On Saturday, those who attend will have the opportunity to work a hypothetical case with the input and guidance of the speakers. Attendees will enjoy a day of training with those committed to improving the appropriate use of minor’s counsel. The training will take place at the Los Angeles County Bar Association, 1055 West 7th Street, 27th floor, Downtown. Parking is available at that address for $10 with validation as well as various lots nearby for less. On-site registration will be available at 8 or 8:35 A.M., with the program continuing until 4:30 P.M. The registration code number is 010267. The prices below include the meals.

- $305—CLE+PLUS members
- $395—nonprofit attorneys
- $400—Small and Solo Division and Family Law Section members
- $495—LACBA members
- $725—all others
- $4,750—6-ticket discount rate

12 CLE hours
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