Los Angeles lawyers David Waite (right) and C. J. Laffer discuss the impact of global warming on CEQA procedures page 22
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Drug War Madness: Policies, Borders & Corruption

Panel 1: Current U.S. Drug Policy and Alternative Paradigms

Confirmed Panelists Include:
Hector Berrellez: Agent, Drug Enforcement Agency
Hon. James P. Gray: Judge, Orange County Superior Court
Asa Hutchinson: Director of the U.S. Drug Enforcement Administration and first Under Secretary for Border & Transportation Security at the U.S. D.H.S
Alex Kreit: Assistant Professor of Law and Director of the Center for Law and Social Justice, Thomas Jefferson School of Law

Panel 2: Cross Border Flows: Drugs, People and Trade

Confirmed Panelists Include:
Jennifer Chacon: Professor of Law, U.C.I. School of Law
Ruben Garcia: Associate Professor of Law, California Western School of Law
Kevin Johnson: Dean and Mabie-Apallas Professor of Public Interest Law and Chicana/o Studies, U.C. Davis School of Law

Panel 3: Narcoterrorism, Organized Crime & Political Corruption

Confirmed Panelists Include:
Steven Casteel: Senior Vice President for International Business Development, GardaWorld
Dr. Rachel Ehrenfeld: Director of the American Center for Democracy
Edward McQuat: Senior Trial Attorney, The Blanch Law Firm

Moderators include Orange County Superior Court Judge James Rogan and Chapman Assistant Professor of Law Ernesto Hernandez. Additional panelists and moderators will be announced.

Keynote Address by Michael Chertoff

Drug War Madness: Policies, Borders & Corruption

Michael Chertoff was the second United States Secretary of Homeland Security under President George W. Bush and co-author of the USA Patriot Act. He previously served as a judge on the United States Court of Appeals, as a federal prosecutor, and as assistant United States Attorney General. Since leaving government service, Mr. Chertoff has worked as Senior “Of Counsel” at the Washington, D.C. law firm of Covington & Burling. He also co-founded the Chertoff Group, a risk management and security consulting company.

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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.

STEVEN L. GLEITMAN, ESQ.
310-553-5080
Biography available at lawyers.com or by request.

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five minutes to closing on a Friday afternoon, they enter the building. No bank customers in sight. Federal Deposit Insurance Corporation (FDIC) officials announce the seizure of another failed bank. By late November 2009, the FDIC had seamlessly performed this ritual 124 times. This far surpasses the 25 taken over in 2008 or the 3 in 2007.

While government officials declare that recovery is imminent, the continued collapse of banks due largely to bad real estate loans reflects the precarious nature of the economy. As the New York Times reported, “[T]hese banks…eased their lending standards…and made big bets on new housing developments, strip malls and office projects.” Before the banks could hit pay dirt, the economy collapsed, with developers defaulting on loans—and taking down their lenders as well. When a bank has been a community’s financial bedrock, local residents and businesses bear the impact of its demise.

A takeover may sometimes ultimately prove beneficial. The Washington Post reported in March 2009 that when a local bank in Georgia failed, it lacked capital, and a third of its loans were nonperforming. When the FDIC stepped in and transferred ownership to a Virginia-based bank, resources became available to make new loans.

For every seizure that might create a better financial outcome, however, countless more appear to exacerbate a community’s economic decline. The successor bank and its management often have little, if any, ties to local businesses and homeowners. Moreover, if this bank applies more stringent lending criteria, access to credit becomes even tighter, if it is available at all, until the acquiring bank establishes local relationships and gains an understanding of the community and its capital needs.

How the FDIC disposes of a failed bank’s loans will determine whether additional adverse effects occur. The FDIC sometimes sells a bank’s loans to investors. Alternatively, the FDIC may enter into a loss-share agreement with the acquiring bank to maximize asset recoveries and minimize FDIC losses. For commercial assets, the FDIC reimburses 80 percent of the losses incurred by the new bank up to a stated threshold amount based on the FDIC’s estimate of projected losses. Any losses exceeding that amount are reimbursed at 95 percent.

Although the new bank faces little financial exposure, loan repayment remains a priority. Many developers, however, find themselves unable to pay off or restructure loans entered into with local banks that failed, because homes can no longer be sold at the original release prices, or credit is unavailable, or both.

Certain banks will try to work with developers. Others, however, take an aggressive approach. Developers and their counsel face an uphill battle to match the bank’s resources. Some walk away and allow the bank to foreclose. The remainder litigate, only to be met by requests for appointment of receivers, writs of attachment, and other legal tactics designed to force an unfavorable settlement.

In the meantime, the community suffers. Developers often employ local labor and buy materials from local merchants. Also, banks are stockpiling properties that will eventually need to be sold, further depressing an already troubled housing market.

While these issues sound like a refrain from last year, real estate attorneys know they will continue to confront them in 2010, if not many more years to come.
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**SERVING A PERSON OR ENTITY** with a summons and complaint to provide notice of a California civil action is a fairly easy proposition if the target is a California defendant—the standard forms of service set forth in the Code of Civil Procedure apply. But serving a defendant in a foreign country can be a more complicated matter, and special international service rules must be considered.

Before attempting service abroad, a practitioner should first consider whether the defendant can be properly served within the United States. For instance, if a foreign defendant company (when “foreign” is synonymous with “overseas” and does not include U.S. states) is qualified to do business in California and has an agent for service filed with the secretary of state, the defendant may be served in accordance with California law. A foreign company can also be served by serving the American subsidiary of the foreign company.

But not all foreign companies have U.S. subsidiaries or agents for service, and individual foreign defendants may not have a residence or place of business here. If service on a foreign defendant within the United States is not possible, then a plaintiff has no choice but to serve the defendant abroad. The best way to avoid service pitfalls overseas is to consult with foreign counsel familiar with the defendant country’s service laws. Foreign counsel will know which service methods are approved by the home courts, those that are the most inexpensive, reliable, and expeditious, and whether international service treaties govern. Foreign counsel can also find reputable process servers and assist with the translation of legal documents. But even if foreign counsel is not employed, a practitioner should be familiar with the most important international service treaty, the Hague Service Convention.

**The Hague Service Convention**

If a party in a foreign country needs to be served with legal papers, a practitioner should first determine whether the foreign country in which the defendant resides or has its principal place of business is a signatory of the convention. The convention is a 1965 multilateral treaty whose purpose is to simplify the procedures for timely serving those abroad and to improve the organization of mutual judicial assistance for that purpose. There are currently 59 contracting nations to the convention, including the United States and many European nations. The convention permits service in a manner approved by a signatory country or by other methods not incompatible with a country’s laws. The convention is not binding on nonsignatory countries.

The defendant country’s convention declarations and reservations should be checked carefully to avoid a service method that the defendant’s country considers objectionable. For instance, Germany has objected to service by postal channels (Article 10 of the convention), so service by mail on a German defendant would be considered improper by California courts for jurisdictional purposes. The Hague Service Convention does not apply “where the address of the person to be served with a document is not known.” Service by publication would then be sufficient for a California court.

If the convention applies, its rules must be followed. If a party does not comply, service is considered void, even if an overseas defendant has actual notice of the action.

**Federal and California Law**

When international treaties do not govern, then federal or California service law applies. For example, in federal cases, Federal Rule of Civil Procedure 4(f) permits service on an individual “by any internationally agreed means of service that is reasonably calculated to give notice,” among other methods. In the case of an evasive foreign defendant, service by e-mail may even be permitted with court approval under Rule 4(f)(3) after traditional means of service have been exhausted.

California’s long-arm statute provides that a California court may exercise jurisdiction on any basis not inconsistent with the California or the U.S. Constitution. For a California action, defendants located outside the United States may be served in any manner authorized for service on a nonresident party within the country, or under the laws of the foreign defendant’s country. Even if a foreign defendant’s country prohibits a service method that is permitted under California law, a California court will deem service as satisfying due process.

A plaintiff complying with California or federal service laws who obtains a judgment against an overseas defendant may have problems enforcing the judgment abroad. Take the example of a German defendant who was served by registered mail, return receipt requested, which is an approved method under California law. A default judgment was subsequently taken. A German court would likely not enforce the California judgment against German assets because Germany has objected to service by postal channels, and service would be considered in contravention of the convention. If enforcement of a judgment abroad is anticipated, then service in accordance with a foreign country’s internal laws is required.

Foreign entanglements can be avoided if a practitioner is armed with knowledge of these basic service rules.

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1. [Corp. Code §2105(a).](#)
5. [Hague Service Convention, art. 1.](#)
7. [Rio Prop., Inc. v. Rio Int’l Interlink, 284 F. 3d 1007, 1015 (9th Cir. 2002).](#)
8. [CODE CIV. PROC. §410.10.](#)
9. [Dr. Ing., 125 Cal. App. 3d at 761-62.](#)

Jeffrey Andrew Hartwick practices business litigation in Torrance.
August 4, 2009

John R. “Jack” Trimarco
9454 Wilshire Blvd., 6th Floor
Beverly Hills, CA 90212

Dear Jack,

I am writing this letter with my deepest thanks for your tremendous efforts in assisting in a murder investigation which focused on my client, Damien Gatewood.

During the early morning hours, shots were fired at a house party in the Southern California area. Tragically, a guest was struck and died. Questionable eye witness identification by one neighbor, identified Damien Gatewood as the shooter.

Mr. Gatewood was arrested days later and had been incarcerated at Wayside Honor Ranch for one year awaiting trial.

I never believed that the authorities had the right man. Your long recognized and unmatched expertise in the polygraph field made you the obvious best choice to perform this critical examination.

You contacted me after you examined Mr. Gatewood. You told me that according to your examination Mr. Gatewood was conclusively not the shooter, a fact which was supported by retired FBI Agent and polygraph examiner Ron Homer, during his quality control.

Armed with the Examination video, polygraph report and your curriculum vitae, I met with the prosecutor assigned to the case. He directed me to the Los Angeles County Sheriff’s Department Polygraph Unit. I met with them to evaluate your test. They all acknowledged your unimpeachable integrity and expertise. They reviewed all charts, documents and video. I was advised by the Unit Chief that you ran a perfect examination and they agreed that Mr. Gatewood was not the shooter. Two days later the case was dismissed and an innocent man was not convicted.

It is a tribute to your reputation that polygraph testing conducted by you is so well received and respected in the legal community.

Warm Regards,

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FOR THE FIRST TIME SINCE THE PASSAGE OF PROPOSITION 13 in 1978, the overall value of property in Los Angeles County has fallen. Assessment appeals boards around the state expect the filing of a record number of appeals to reduce the value of properties. California attorneys should be aware of the proper way to file and prosecute an appeal so that the taxpayer can receive the greatest amount of property tax savings.

The adoption of Proposition 13 in 1978 changed California property tax from an annual lien date appraisal system to an acquisition date valuation system. Proposition 13 provides that the taxable base-year value of real property will be the full cash value of the property as of March 1, 1975, unless there has been a subsequent purchase, new construction, or change of ownership. Proposition 13 further provides that the base-year value can be increased each year by an inflation rate of no more than 2 percent.

Soon after Proposition 13’s passage, the electorate enacted another property tax ballot measure, Proposition 8. It made clear that real estate that declines in value may be assessed below its base-year value. After the passage of Proposition 8, the court of appeal in State Board of Equalization v. Board of Supervisors held that assessors had to recognize declines in value and that a failure to do so would be an unconstitutional denial of equal protection, whether or not Proposition 8 had passed.

In 1995, the legislature adopted Senate Bill 821, Chapter 491. The bill relettered Revenue and Taxation Code Section 51 to clarify that after a Proposition 8 reduction adjusting the fair market value of a property downward to reflect the current market value, the property must be annually reappraised until the current market value exceeds its factored base-year value. Also in 1995, the legislature passed Assembly Bill 1620, Chapter 164, to allow an assessor an extra year to enroll a decline in value. This bill permitted an assessor to correct any error or omission, within one year of the erroneous assessment, involving the exercise of a value judgment that arose solely from a failure to reflect a decline in taxable value of property as required by a specified statutory provision.

Following the passage of Proposition 8, some taxpayers argued that the 2 percent cap imposed by Proposition 13 applied after a Proposition 8 decline in value, and thus the assessor’s office could only raise the Proposition 8 value of property by, at most, 2 percent. The case of County of Orange v. Bezaire settled this issue.

In Bezaire, the taxpayers purchased a property in 1995 for $330,000. The Orange County assessor enrolled that value of the property as the base-year value. The following year the property had not gained value, and the assessor enrolled $330,000. In 1998, the assessor increased the value to $343,332, which was an increase of 2 percent for the years 1997 and 1998, compounded. This increase amounted to more than a 4 percent increase over the previous year’s tax bill. The taxpayers filed suit, arguing that increases were limited to 2 percent of the previous year’s enrolled value.

The court in Bezaire analyzed 1) the text of Proposition 13, as modified by Proposition 8, 2) the technical structure of Proposition 13, and 3) the intent of the drafters of Proposition 13 and Proposition 8. The court determined “that the base on which the inflation factor is figured remains that of the original purchase price (or assessment at time of genuine new construction), not any reduced base resulting from a reassessment in the wake of a decline in property values....” Accordingly, the court held that assessments are not always limited to no more than 2 percent of the previous year’s assessment, affirming the assessor’s 4 percent increase in assessed value.

Currently, an assessor is required to assess each parcel of real property at the lower of the factored base-year value or current market value, but an assessor is not required to annually review each prop-
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property. As a result, many properties that experience declines in value may not be enrolled at the lower value. The burden is on the taxpayer to file an application for changed assessment.

Taxpayers may file for a Proposition 8 decline in value in two ways. The first is through an informal process, which involves completing a county-issued form. The taxpayer must file the form before the January 1 lien date, except in Los Angeles County, which allows for an informal filing until July 1. The informal process is not a formal remedy, and it does not exhaust administrative remedies. Taxpayers should include at least two comparable sales and a description of the comparables. For commercial and industrial properties, the description should include the income expenses, building and land size, use, zoning, year built, and proximity of the comparables. For single family or multifamily buildings, the description should include building size, year built, number of bedrooms and baths, proximity—and in the case of multifamily buildings, the number of units and the income expenses.

The second way to file for a Proposition 8 decline in value is the formal process of filing a verified application with the Assessment Appeals Board (AAB) on a form prescribed by the State Board of Equalization (SBE) and provided by the county. The filing of a Proposition 8 application only concerns one tax year, so it is important for taxpayers to file an appeal every year until the fair market value of the property exceeds its trended base-year value. The failure to timely file will likely eliminate the ability to recover for a decline in value for that year. Since taxpayers can easily withdraw appeal applications, it is prudent to file a Proposition 8 application every year that there may be a decline in value below the trended base-year value.

The timely filing of the appeal application is a crucial part of the formal Proposition 8 appeal process. A missed deadline could mean the end of the case, because filing periods are jurisdictional and the AAB has no authority to hear an untimely application.

**Tax Assessment Appeal Procedures**

Formal or informal, the key to a filing for a Proposition 8 decline in value is the assessment. Assessors can make three types of property tax assessments: 1) regular assessments, 2) escape assessments, and 3) supplemental assessments. A regular assessment is the type made for the current tax year as of the January 1 date of valuation, also known as the lien date. The appropriate assessment appeal filing period depends upon which county the property in question is located. Applications are due between July 2 and September 15 of the year in which the assessment is made. But if the county assessor does not send notice for the entire county of the assessed value of property prior to August 1, the deadline to file an appeal is extended from September 15 to November 30.

The counties that provide this notice can change yearly. The county assessor must notify the clerk of the county board of equalization and the county tax collector by April 1 of each year as to whether it will provide the notice by August 1. Thus, a county may have a November 30 deadline one year and a September 15 deadline the next. The SBE produces a statewide listing each year that sets forth the applicable filing deadline for each county. If a notice of assessment is not received at least 15 days prior to the deadline to file an appeal, an appeal may be filed within 60 days of receipt of notice of assessment or 60 days from the mailing of the tax bill, whichever is earlier. When this happens, in addition to the appeal application the taxpayer must include an affidavit declaring that the notice was not timely received.

The second type of assessment is an escape assessment, which is an increased amount in real property valuation over the regular assessed valuation. Escape assessments typically result from a delay in the reappraisal of a property and are considered an assessment made outside the regular assessment period. An application appealing an escape assessment must generally be filed no later than 60 days after the date of mailing printed on the notice of assessment or the postmark date, whichever is later.

However, the appeal application deadline differs in Los Angeles County and in counties that have adopted a resolution in accordance with Revenue and Taxation Code Section 1605(c). In Los Angeles, taxpayers may file appeals no later than 60 days after the mailing date of the tax bill or the postmark, whichever is later. Counties are required to issue a notice of intention to enroll an escape assessment. Many counties as well as the SBE take the position that filing on this notice and before the notice of enrollment is premature and therefore void.

The third type of assessment, a supplemental assessment, is an assessment made due to a Proposition 13 base-year reappraisal because of a change in ownership or completed new construction. A supplemental assessment is supplemental to the regular roll. Two supplemental bills will be issued if there is a change in ownership or completed new construction between January 1 and May 31. The first supplemental assessment is based on the new base-year value and the taxable value on the current roll. The second is based on the new base-year value and the taxable value to be enrolled on the roll being prepared, for the fiscal year beginning July 1, following the date of the change of ownership or completion of construction.

Supplemental assessments are considered assessments outside of the regular assessment period. Taxpayers must generally file an appeal no later than 60 days from the date of notice. Like escape assessments, in Los Angeles County taxpayers must file the appeal no later than 60 days from the date of mailing of the tax bill.

However, an application may be filed within 12 months after the month in which the assessees are notified of the supplemental assessment. This may occur only if the taxpayer and the assessor stipulate to error in the assessment that resulted from the exercise of the assessor’s value judgment, and a written stipulation as to the full cash value is filed.

If the taxpayer misses a deadline, an audit of the business property by a county assessor may afford the taxpayer another opportunity to contest the value of all the property, including the real property at the location. Section 469 provides, “[I]f the result of an audit for any year discloses property subject to an escape assessment, then the original assessment of all property of the assessees at the location...for that year shall be subject to review, equalization, and adjustment.”

**Claims for Refund**

Even if the taxpayer wins at the AAB and it orders a reduction in the value, the taxpayer will not receive a refund unless the taxpayer timely files a claim for refund with the county board of supervisors. An assessment appeals application can be designated as a claim for refund. This practice is often beneficial as it eliminates the possibility of failing to timely file a claim for refund. Some drawbacks are possible.

One is that a taxpayer may omit from the application the grounds for a refund. This may preclude the taxpayer from arguing those grounds on appeal. Recent annotations to SBE Rule 305(f) seek to mitigate this concern by providing that when the applicant designates an application as a claim for refund, the applicant has effectively challenged all findings made by the AAB. Another drawback is that an action on the appeal application is an action on the claim for refund, and if the AAB does not order full relief, the action constitutes a denial of the claim for refund, and the time period for filing suit begins. A claim for refund is a prerequisite to filing suit for refund, and the suit must be filed within four years of the refund sought. The time period runs from the date of payment of the tax and not from when the payment was due.

In certain situations, the time period for filing a timely claim for refund is not the general four-year period. If the tax collector
mails a notice of overpayment, then the period to timely file a claim for refund is one year from the date of notice of overpayment. The time period is also one year if the appeal application does not state it is intended to be a claim for refund and one of the following events occur: 1) if the AAB makes a final determination on the appeal application, mails written notice of its determination to the applicant, and the notice does not advise the applicant to file a claim for refund, or 2) if the AAB fails to make a final determination within two years of the filing of an application, and no waivers have been obtained. The time period to file a claim for refund is six months if the AAB makes a final determination on the appeal application, mails written notice of its determination to the applicant, and the notice advises the applicant to file a claim for refund. 

After the timely filing of the AAB application, the taxpayer should commence discussions with the assessor regarding the valuation of the property (or other potential issues). It is very important to attempt to work with the assessor and not immediately turn the conversations into adversarial confrontations. Normally, the applicant can achieve a much more satisfactory result with an assessor than the AAB. If the applicant is correct, the assessor may concede the point, whereas the AAB will often choose a value in the middle of the taxpayer’s valuation and the assessor’s.

Meeting with the Assessor

When meeting with an assessor, the applicant will want to provide as much helpful information about the property as possible. Providing information and data to an assessor is quite frequently advantageous because the applicant will often achieve better results if the assessor uses the information provided by the applicant. The applicant needs to be prepared to speak with the assessor in technical terms of appraisal. The applicant should have a strong understanding of the three methods of valuation (income, cost, and comparable sales) and the rules that apply to property tax appraisal. For example, discount rates are done on a pretax basis. Further, private restrictions are not considered, but public restrictions are considered. Thus, when estimating a property’s income capability, assessors ignore existing leases in a commercial building in favor of current market rents.

If the applicant cannot convince the assessor to change the valuation of the property, an AAB hearing is the next step in the appeals process. First, the applicant should gather all the relevant information regarding the assessment and the property. Next, the applicant may initiate an exchange of information under Section 1606. This is initiated by submitting the following data, in writing, to the assessor and the AAB clerk: 1) information stating the grounds for the party’s opinion of value, 2) if using comparable sales, information identifying the comparable properties, 3) if employing the income approach, information regarding the income, expense, and capitalization method, and 4) if using the cost approach, information relating to the date and type of construction, replacement cost, obsolescence, allowance for extraordinary use of machinery and equipment, and depreciation. As a practical matter, taxpayers typically supply their expert’s written appraisal report to initiate or respond to these exchanges.

An exchange of information must be initiated at least 30 days before the commencement of the hearing. The assessor must submit the appropriate information to the initiating party at least 15 days prior to the hearing. Whenever information has been exchanged pursuant to Section 1606, the parties may not later introduce evidence at the hearing that was not exchanged, unless the other party consents. However, each party may introduce new rebuttal material relating to the information received from the other party.

The applicant should also make a Section 408 request to inspect or copy any information in the assessor’s possession, including market data. This includes any information that relates to the sale of any property comparable to the property of the assessee, if the assessor bases the assessment in whole or in part on that comparable sale or sales. Further, the assessor, upon request, shall permit the copying or inspection of all information, documents, and records, including auditors’ narrations and work papers, relating to the appraisal and the assessment of the property.

Assessors can obtain more information than required by the exchange of information provisions by resorting to Section 441. Section 441(d) details a list of information that must be made available, upon request, to the assessor for assessment purposes. Although technically not part of the AAB process, Section 441(h) allows the assessor a continuance of the AAB hearing if the taxpayer fails to provide information under Section 441(d) and introduces any requested materials or information at any assessment appeals hearing. Assessors have often used Section 441(h) to continue hearings when the taxpayer fails to provide Section 441(d) material even though no Section 441(d) material was introduced at the hearing.

In addition to fact gathering, the applicant should engage an appraiser at the very beginning of the process. This allows the appraiser adequate time to develop a thorough appraisal. The appraiser should be familiar with California property tax valuation standards. The applicant should carefully review the first draft of the appraisal to eliminate any errors and to confirm that it conforms to California specific property tax valuation procedures.

With a commercial property, it is important to remember that the applicant typically carries the burden of proof. Similar to any presentation to a trier of fact, the applicant should select qualified and well-spoken witnesses who have the ability to defend their statements on cross-examination. The applicant should also prepare exhibits to support the applicant’s story.

When preparing exhibits and prepping witnesses, attorneys should remember that the AAB is composed of lay people with limited time to digest the facts. Thus, everything submitted must not only be accurate but also simple enough so that the AAB can comprehend the arguments.

The lack of technical expertise by the AAB is another reason why working with the assessor is important. The assessor often has the expertise and knowledge that AAB members may lack. Thus, the assessor may be more willing to accept technical arguments. Further, the assessor has more time to consider the various issues. Finally, if the applicant believes that the case will ultimately go to superior court, the applicant must request written findings of fact prior to the commencement of the hearing and pay for them prior to the conclusion of the hearing. The option of superior court does not mean that the applicant can defer effort until the case goes to superior court.

After the AAB Hearing

In fact, in practical terms, unless there is a distinct legal error, there really is no appeal after the AAB hearing, because it is extremely difficult to get a reduction once the AAB has determined a value. For property tax matters, the superior court acts as an appeals court. The superior court gives questions of law de novo review but reviews questions of fact using a substantial evidence standard. Further, even if the taxpayer wins on a legal issue, the court merely remands the case to the AAB to correct the legal error. On many, if not most remands, after correcting the legal error, the AAB does not materially change the value. Therefore, almost all of the applicant’s effort should go into working with the assessor and the preparation of a compelling case to be presented before the AAB.

The bursting of the real estate bubble caused property values to significantly decline. Proposition 8 mitigates the negative effects of
decreasing property values by permitting reductions in assessed value for properties that have declined in value below their trended base-year value. In order to assure the best possible property tax result, taxpayers should consult with property tax practitioners that are experienced with the procedures and substantive issues of property tax law. An experienced practitioner will be able to use expertise and knowledge to navigate through the administrative procedures, work with the assessor, and obtain the most favorable valuation possible.

5. Id.
6. See AB 1620, ch. 164.
8. Id. at 126.
9. Id. at 136-7.
10. Id. at 137.
12. Rev. & Tax. Code §1603(a) and Cal. Property Tax Rule 305.
13. Rev. & Tax. Code §1603(c) and Cal. Property Tax Rule 305(d).
15. Id.
19. Id.
22. Rev. & Tax. Code §1605(c) and Cal. Property Tax Rule 305.
25. Rev. & Tax. Code §75.31(a).
30. See McDougall v. County of Marin, 208 Cal. App. 2d 65 (1962) (the statute of limitations does not begin to run until the time of the payment of the last installment).
38. Id.
40. Rev. & Tax. Code §408(c)(1).
41. The proper procedures can be found in the State Board of Equalization’s property tax rules and assessors’ handbook sections.
42. Rev. & Tax. Code §1611.5.
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Stop Notice Risks for Construction Lenders

CONSTRUCTION LENDERS FACE MYRIAD CHALLENGES in the plunging economy and real estate market. The difficulties include handling a heightened number of borrower defaults, deciding whether to continue disbursing construction loan funds in a declining market, and determining how to weigh the risks of foreclosing and completing construction on an incomplete project. While navigating these obstacles, lenders should always evaluate their potential liability to contractors and suppliers for bonded stop notices.

By serving a bonded stop notice claim on the lender, contractors and suppliers can effectively lien any undisbursed construction loan funds. The failure of a construction lender to honor a proper stop notice can result in substantial exposure. Construction lenders that ignore a bonded stop notice claim on a private work of improvement do so at their peril.

A stop notice is a written and verified statement served by a claimant owed money on a work of improvement. The statement must identify the claimant and describe the nature of the labor, materials, or services provided; the name of the party to whom these were furnished; the dollar value of what was furnished; and the amount claimed as due. By serving a valid stop notice on a construction lender, a stop notice claimant creates a claim or lien on undisbursed construction loan funds in the hands of an owner or lender for the benefit of the claimant. This remedy allows contractors, subcontractors, and materialmen to reach undisbursed construction loan proceeds as security against nonpayment. Once a bonded stop notice is served, the lender must withhold from available construction loan funds an amount sufficient to pay the stop notice claim and may not use that withheld amount to pay down the principal amount of the loan or to pay interest, fees, or other costs.

“A bonded stop notice” is defined as a stop notice given to a construction lender that is accompanied by a bond in a penal sum equal to 1.25 times the amount of the claim. A construction lender is only obligated to withhold funds from an owner/borrower if properly served with a bonded stop notice. Indeed, a construction lender is not obligated to honor a stop notice that is not bonded. The construction lender must withhold funds pursuant to a bonded stop notice served by an original contractor, subcontractor, or first-tier supplier.

The stop notice claimant also may demand in its stop notice that the lender provide a copy of any payment bond. If there is a payment bond recorded for the project, different rules apply. When a payment bond has been recorded, the lender is not required to withhold funds but may do so at its option. This applies to all proper claimants other than the original contractor. Similarly, an owner served with a stop notice is not required to withhold funds when a payment bond has been recorded but may do so at its option. If an owner declines to withhold funds in response to a stop notice because a payment bond has been recorded, then the owner must furnish the claimant with a copy of the payment bond.

A valid stop notice can be a highly effective remedy for a claimant seeking to obtain payment for its work. A lender that improperly disburses funds subject to a stop notice is personally liable for the amount due to the lien claimant under the contract with the owner (but not exceeding the maximum amount of unexpended construction funds). Further, the stop notice remedy is independent and cumulative of a claimant’s rights to a mechanic’s lien, to enforce any payment bond, and to pursue a writ of attachment. Thus a claimant may avail itself of all prejudgment remedies simultaneously. Like mechanic’s liens, stop notices are nonconsensual and do not require prior judicial approval. Moreover, lien and stop notice rights may not be waived by contract, reflecting a strong public policy favoring payment for those who improve property. Similarly, no assignment by the owner or contractor of construction loan funds—whether made before or after service of a stop notice on a construction lender—has priority over the stop notice claimant. Assignments cannot defeat the rights of stop notice claimants.

Stop notices differ from mechanic’s liens in that they attach to the funds of the owner of the property, or the construction loan proceeds from a lender, rather than to the real property being improved. As a result, a stop notice survives a foreclosure of the property. Thus, stop notices do not give rise to the priority issues regarding the construction lender’s deed of trust that emerge with mechanic’s liens. If several stop notices have been filed and not enough money exists to pay them all, stop notice claimants share pro rata in the available funds.

Limitations and Requirements

Statutes limit who can assert a stop notice. In general, California law provides that all persons and entities qualified to record a mechanic’s lien, with the exception of the general contractor, may serve a stop notice on the owner. This includes materialmen, subcontractors, first-tier suppliers, equipment lessors, licensed design professionals, union trust funds, and those who make improvements to the site. These same classes of claimants, plus the general contractor, may serve a stop notice on the construction lender. Only when the stop notice is bonded is the lender required to withhold funds.

Robert G. Campbell is a senior counsel at Cox, Castle & Nicholson LLP, where he specializes in litigation involving construction disputes and counsels clients regarding troubled construction projects.
Arthur Mazirow received his Bachelor of Science Degree from the UCLA School of Business, specializing in real estate, and his J.D. from the UCLA School of Law. He has represented clients in several thousand real estate transactions involving purchases, sales, leasing, financing, brokerage, joint ventures, and development.

In programs sponsored by the extension divisions of UCLA and the UC system, the State Bar of California, Bar Associations and various real estate groups, he has given hundreds of lectures on real estate topics to lawyers and real estate professionals. He has also published more than 100 articles dealing with the legal aspects of real estate transactions. From 1972 to 1990, he was a principal author of the lease and purchase forms published by the American Industrial Real Estate Association (AIREA). He is also a member of Counselors of Real Estate, a national association and the 2008 Chair of its Dispute Resolution Program. A detailed C.V. is available at www.mazirow.com.

He now acts only as an arbitrator, mediator, expert witness and as a consultant to law firms representing clients in real estate disputes. His arbitration and mediation activities are through the American Arbitration Association, as well as independently. He has also been designated as a trial referee under the Reference Procedure of the California Code of Civil Procedure.

**Arbitration, Mediation & Law Experience of Arthur Mazirow**

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Stop notice claimants need not wait until their work is complete to serve a stop notice. This is in contrast to mechanics’ lien claimants, who must wait until their work or the overall work of improvement is complete. Nevertheless, stop notice claimants must take numerous technical steps to ensure that their stop notices are valid. They must serve a proper 20-day preliminary notice in a timely manner. Service must take place “prior to the expiration of the period within which [the claimant’s] claim of lien must be recorded under [Civil Code] Section 3115, 3116, or 3117.” These sections calculate the expiration of the service period as a specified number of days after the completion of the work of improvement or the recording of a notice of completion.

In most cases, owners or lenders have not recorded or served valid notices of completion for completed projects. When that happens, claimants have 90 days from completion of the project to serve a stop notice. That period is shorter when a valid notice of completion has been recorded and served, or when a valid notice of cessation has been recorded. Claimants must pay careful attention to these prerequisites to perfect their stop notice rights.

If owners or lenders dispute the validity of the stop notice, they must post a stop notice release bond in an amount 1.25 times the amount of the stop notice. Only upon the filing of the bond, which has the effect of providing substitute security for the claim of the stop notice claimant, can the withheld funds be released.

Similar to a mechanic’s lien claimant, a stop notice claimant must take prompt legal action to enforce the stop notice. An action to enforce the stop notice may be commenced at any time after 10 days following service of the stop notice but no later than 90 days following the period in which a mechanic’s lien could be recorded. If no action is commenced within the prescribed period, the stop notice ceases to be effective, and withheld funds must be paid to the person to whom the funds are owed. If an action is commenced, notice must be given within five days. When multiple actions to enforce a stop notice are filed, a motion to consolidate may be filed so that the actions will be adjudicated together in one proceeding.

A significant distinction between a mechanic’s lien foreclosure action and a stop notice enforcement action is the right of bonded stop notice claimants to recover their attorney’s fees if they are determined to be the prevailing party. By statute, prevailing party claimants also will be awarded interest at the legal rate. Interest accrues from the date of service of the stop notice.

Construction lenders facing a stop notice claim should understand that the statutes governing stop notices are remedial and are liberally construed to effect their objectives and to promote justice. Therefore, while certain deadlines are strictly enforced (such as the deadline for a claimant to commence legal action to enforce a stop notice), other requirements are liberally construed in favor of the claimant. Stop notices are designed to protect materialmen who furnish labor and materials that enhance the value of the property and are supposed to be paid out of the construction fund.

As one court reasoned, a lender’s senior deed of trust usually protects the lender from the risk of default. Meanwhile, a lender may protect against the risk of nonpayment of claimants by requiring the owner or developer to post a payment bond. Also the lender can inspect the progress of the construction, issue joint checks, or institute other funding controls. The court further noted that permitting a claimant to recover against the lender for materials and labor contributed to the property is appropriate because those contributions increase the value of the property and therefore enhance the lender’s security. In addition, the court declared that strong policy reasons support requiring commercial lenders to police the building industry—and the stop notice remedy encourages this as well.

The purpose of a stop notice is to provide materialmen with protections when they extend their resources in return for a future payment from a construction fund. Most often smaller companies are the ones who file stop notices—companies that have provided labor or materials to a project without the resources to litigate. When balancing the protection of claimants expending their labor and materials against owners or lenders receiving the benefit of those goods and services, the equity scale usually tips in favor of claimants.

Because the stop notice remedy is so highly effective for stop notice claimants, construction lenders have made several attempts over the years to structure a construction loan that effectively circumvents it. In light of the policies in support of the remedy, lenders have not met with much success in trying to defend against stop notices. For example, in a case involving a borrower/owner that assigned to the lender the loan fund under an agreement to make specified progress payments to the contractor, the lender could not defeat a stop notice claim by asserting a right to retain the assigned fund as security for repayment of the loan.

Courts have held that a stop notice will reach an undisbursed loan fund even following a default by the borrower terminating the borrower’s right to obtain further disbursements from the loan fund. According to these courts, if a lender could evasively assert the purpose of the stop notice statute by simply not creating a separate construction fund, then every set of construction loan documents in California would do the same, and bonded stop notices would become ineffective. This result would be contrary to the purpose of stop notices as defined by California courts. To permit lenders to do otherwise would allow them, upon foreclosure of a property, to have the benefits of the provided materials and labor without payment—and deprive lien claimants of any effective remedy.

Stop notice priority extends to all loan funds that remain subject to disbursement—even those that may not be due under the lender/borrower construction agreement because disbursement conditions have not been satisfied. This priority is unchanged even if the borrower is in default. As a consequence, a lender may not properly defeat a stop notice by insisting that no undisbursed funds exist because the borrower is in default and the lender is therefore not obligated to disburse those funds. Private agreements between lenders and borrowers may not serve as a defense to a stop notice claim.

In a seminal decision, Familian Corporation v. Imperial Bank, the court refused to allow a lender to preallocate construction loan funds to an interest reserve and thereby effectively subordinate perfected stop notice claims to the interest reserve. The court held that the lender may not pay itself fees, points, and interest in preference to stop notice claimants at the inception of the loan, thus reducing the loan fund and achieving priority over liens or stop notice claimants. This practice violates the antiaignment edict of the stop notice statutes. Lenders also are judicially prohibited from attempting to achieve priority by 1) applying the loan balance to reduce the amount due under the construction note, and 2) depositing unexpended construction loan funds into a general fund or separate escrow account.

Construction Funds and Lender Liability
Conflicts sometimes arise over what constitutes a construction fund. In part this controversy stems from the fact that the California Civil Code does not currently contain a provision specifically defining a “construction fund” for purposes of stop notice claimants. However, former Code of Civil Procedure Section 1190.1(b)—the predecessor to Civil Code Section 3166—defines “construction fund” as the amount either “furnished or to be furnished by the owner or lender...as a fund from which to pay construction costs” or “arising out of a construction or building loan.” Civil Code Section 3087 defines a “construction lender” as any mortgage lending funds to pay for the cost of the work of improvements on a property or a “party holding funds furnished or to be furnished by the
owner or lender or any other person as a fund from which to pay construction costs."

The plain language of the Civil Code and its predecessor in the Code of Civil Procedure broadly treat a construction fund as any amount of money designated to be used to pay construction costs. In both Civil Code Section 3087 and former Code of Civil Procedure Section 1190.1(h), the only requirement for establishing a construction fund is that an amount must be designated as "a fund from which to pay construction costs." Therefore, a construction loan agreement that specifies the loan proceeds as the money for paying construction costs would qualify as a construction fund for the purposes of stop notices.

The amount retained by the lender in response to a bonded stop notice should not be used to pay down the principal amount of the loan or to pay interest, fees, or other costs owed to the lender. A lender that fails to properly withhold undisbursed loan proceeds following a bonded stop notice is personally liable for the amount due to the lien claimant. Nevertheless, the lender will not be liable for more than the amount of the undisbursed loan proceeds at the time the bonded stop notice was served.

**Following Familian**

The *Familian* decision should guide lenders in their response to bonded stop notices. In *Familian*, a construction lender received bonded stop notices that far exceeded the undisbursed loan balance. Meanwhile, the lender had paid itself interest and fees from a reserve account specifically set up to pay interest on the loan and other fees owed to the lender as those amounts accrued. The claimant contested the right of the lender to pay itself from the reserve account before the stop notice was served, and the court agreed with the claimant.

According to the *Familian* court, the practice of payment from an interest reserve constitutes a statutorily prohibited assignment under Civil Code Section 3166. The court held that the lender may not pay itself fees and interest in preference to stop notice claimants. To do otherwise would permit the lender a double recovery by allowing it to capture fees and interest as well as the enhanced value of its property. That enhanced value is created by the construction work performed by the claimants.

The effect of the *Familian* decision is huge, because it can lead to lenders being required to disgorge amounts they have paid to themselves in earned interest and expenses. It also follows under *Familian* that construction lenders with fully disbursed loans remain at risk.

In addition, when a construction loan is sold, a preexisting bonded stop notice claim

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is not defeated by the transfer. The original construction lender served with the bonded stop notice remains obligated. Therefore, construction lenders should procure appropriate indemnities or take other actions to safeguard against this risk when selling a loan subject to a bonded stop notice.

Some have questioned the rationale of the Familian decision and consider it poorly reasoned. For example, in Steiny v. Real Estate, Inc., another appellate court disagreed with Familian and ruled that a lender was entitled to keep payments made to itself from the loan fund to the extent those amounts were earned prior to service of the stop notice. However, the Steiny case was decertified from publication. Familian, warts and all, remains existing law and must be heeded by lenders.

Lenders seeking to defend against a stop notice claim should first evaluate whether the prerequisites for a stop notice have been met, such as verifying that the claimant is among the categories of claimants that possess stop notice rights. Moreover, in the appropriate circumstances, lenders should discern if the claimant was properly licensed. Also, a lender should work with the borrower to determine the merits of the amount claimed to be due and attempt to compel the borrower to resolve the dispute with the claimant. A lender should consider demanding that the property owner secure a stop notice release bond if a legitimate dispute exists.

Ultimately, owner/borrowers and lenders share a strong incentive to keep stop notices from interfering with timely project completion. An incomplete and delayed project increases construction costs and undermines the value of a lender’s security. In addition, if a lawsuit is filed to enforce the stop notice and is accompanied by a mechanic’s lien foreclosure action, the lender should consider whether to tender the lawsuit to the title insurer. Finally, lenders may need to consider whether to file an interpleader action, in which they may be entitled to recover their attorney’s fees.

1 Stop notices on public works projects are governed by different rules.
2 Civ. Code §3103.
5 Civ. Code §3083.
7 Civ. Code §3159(a)(3).
8 Civ. Code §3159(a)(2).
As 2010 begins, real estate law practitioners in California must deal with two realities: The real estate market continues in its deep freeze, while climate change is a hot topic. Typically, national and international policies and events—including the Kyoto Protocol and the United Nations Climate Change Conference in Copenhagen—have taken the spotlight in addressing the issue of climate change. Last year, federal appellate court opinions from the Second and Fifth Circuits held that state and local governments as well as property owners have standing to seek injunctions to prevent greenhouse gas (GHG) emissions under common law nuisance theories. Nevertheless, California is charting an active course of its own in regulating GHG emissions. The state has done so with the enactment of a variety of new statutes and regulations combined with an expansive interpretation of the California Environmental Quality Act (CEQA) by state trial courts. These mandates and decisions have important implications for real estate developers and investors as well as regional agencies and local governments. All parties in the development process must evaluate project plans in light of their contribution to the global phenomenon of climate change. Indeed, the issue is certain to play an increasingly prominent factor in CEQA litigation.

California’s prominence in the climate change debate should not be surprising. During the last four decades, California has been at the forefront of cutting-edge environmental and land use regulation. In 1970, California enacted CEQA, which closely mirrors the federal National Environmental Policy Act (NEPA). More recently, the Federal Environmental Protection Agency (EPA) granted a controversial waiver to California that permits the adoption of state-mandated tailpipe emissions standards. California is a national leader in the adoption of innovative policies and legislation addressing environmental degradation.

During this same period, California’s economy has been tied to the fortunes of the real estate development and construction industries. As a result, the state is suffering severely in the current economic downturn, with tight credit markets, increasing commercial vacancy rates, and skyrocketing foreclosures for commercial and residential properties. Local governments are facing a mounting fiscal crisis as local

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sales and property tax revenues continue to decline. Reviving dormant or expired entitlements (such as tentative tract maps, specific plan approvals, development agreements, master development plans, and conditional use permits) may require partial or wholesale revisions.

The current condition of the capital markets and the broader economy present a host of challenges to real estate developers, investors, and lenders throughout California. The evolving standards of environmental review under CEQA require a focused evaluation of the impact of GHG emissions anticipated to be generated by proposed development projects.

**CEQA Standards and Procedures**

The legislative intent of CEQA is to ensure that decision makers and the public have access to information regarding the environmental effects of proposed government actions. Under CEQA, all projects are subject to an environmental impact analysis by government agencies. Typically, an environmental impact report (EIR) entails analysis of a proposed project’s effect on natural resources (such as air and water quality), biology, land use, traffic, public infrastructure, historic resources, noise, and aesthetics. Although direct, indirect, and cumulative effects have been considered under CEQA, the geographic scope of those analyses was relatively limited.

CEQA does not expressly prohibit the development of projects that result in significant environmental effects—but it does require a feasible mitigation of them. Under CEQA, lead agencies may approve a project that results in a significant environmental impact that is “not avoided or substantially lessened” if agencies determine that the project’s benefits outweigh the unavoidable adverse effects. Agencies do so by adopting a Statement of Overriding Considerations for the project.

Under CEQA, a lead agency conducts an initial study of a proposed project with two inquiries:

1) Does the governmental action required for the proposed development make it a “project” as defined by CEQA?

2) If so, is there substantial evidence that the project may have a significant effect on the environment?

If the substantial evidence threshold is not met, then the lead agency can prepare a negative declaration (ND) or a mitigated negative declaration (MND). However, if the lead agency determines that a project “may have a significant effect on the environment,” the agency must prepare a detailed review, in the form of an EIR.

This is a costly and time-consuming process that offers extensive opportunity for public comment.

Agencies may rely on “thresholds of significance”—quantitative or qualitative standards for a particular environmental effect—in determining whether an impact is significant. If the agency finds that an environmental effect is significant, CEQA requires that the agency’s EIR discuss “feasible measures which could minimize significant adverse impacts.” Under Proposed CEQA Guidelines developed pursuant to recent legislation, the lead agency in its environmental review process must “describe, calculate, or estimate the greenhouse gas emissions resulting from a project.” Lead agencies may then compare these emissions against thresholds of significance to determine the scope of the environmental impact. As part of the review process, project proponents must adopt practices or otherwise revise a project to mitigate its impact—or the agency can approve a project with less than full mitigation by adopting a Statement of Overriding Considerations.

With current statutory, regulatory, and case law trends addressing whether a project will have an adverse environmental impact on climate change, real estate transactional lawyers and land use practitioners must address a number of issues for their clients. What if previously granted entitlements, with approved MNDs or certified EIRs, must now be changed in order to respond to new market conditions? What are the implications for environmental review in light of CEQA’s “changed circumstances” or “new information” legal standards? What is the scope of factors for projects that must be analyzed to determine the presence of any potential environmental impact on climate change? What are the methods for establishing baseline conditions and evaluating project-specific and cumulative impact? When is a project’s impact on climate change considered significant enough to warrant further analysis? What are effective and legally defensible mitigation measures?

The issue of determining whether various environmental approvals and land use entitlements have “vested” is particularly important given the current turbulence in the real estate market. Under the well-established *Arco* rule, a property owner in California only acquires a vested right to develop a project in conformance with the standards in place when the project is approved. Vesting occurs with the performance of substantial work and the incurring of substantial liabilities as a result of a good faith reliance on a validly issued building permit. Under Government Code Sections 68564 et seq., a property owner or developer may enter into a development agreement with a city that entitles the owner or developer to develop a project according to the terms of the agreement for a period of 10, 15, or 20 years. In addition, the owner or developer obtains a vested right to “freeze” the applicable development standards for a specified period in exchange for dedications, voluntary conditions, and other development exceptions and public benefits.

Once a project has received and vested all necessary entitlements as well as the required environmental CEQA clearance, there is no need for a further EIR, ND, or MND unless the physical project changes. If the proposed project does require some new discretionary approval, this will trigger the need for additional environmental review in compliance with CEQA. This can be accomplished for certain changes with an administrative addenda to the original EIR. However, if either the proposed project, or the circumstances under which the project is undertaken, are the subject of “substantial changes” involving “new significant environmental effects or a substantial increase in the severity of previously identified significant effects,” a review known as a Subsequent EIR may be required. A Subsequent EIR is also mandated when “new information of substantial importance, which was not known and could not have been known with the exercise of reasonable diligence,” shows previously unaddressed significant effects, or substantial increases in the severity of previously discussed effects.

Therefore, real estate developers and investors involved in projects that remain subject to further discretionary action should be prepared for project opponents to claim that the absence of a GHG analysis in previously adopted environmental clearances, or new information regarding a project’s climate change impact, warrant additional environmental review. This may occur even if the physical characteristics of the proposed project have not changed.

**Legislation Affecting CEQA Guidelines**

In 2006, the California Legislature enacted AB 32, the California Global Warming Solutions Act of 2006. This law requires the California Air Resources Board to adopt regulations aimed at reducing statewide GHG emissions to 1990 levels by 2020. Although AB 32 did not expressly amend CEQA, some commentators, environmental advocates, and officials interpret the statute’s findings—including the statement that “[g]lobal warming poses a serious threat to the economic well-being, public health, natural resources, and the environment of California”—as an expression of the California Legislature’s intent to interject climate change into CEQA review.

In the wake of AB 32’s enactment, the legislature took another giant step toward integrating global warming analysis into local policy and decision making. In August 2007, the legislature passed SB 97, which...
requires the governor’s Office of Planning and Research (OPR) to
develop and prepare by July 1, 2009, new CEQA Guidelines for the
mitigation of GHG emissions. These guidelines would address effects
“including, but not limited to, [those] associated with transportation
or energy consumption.” The law also provides for the California
Natural Resources Agency to certify and adopt the amended guide-
lines by January 1, 2010. The OPR submitted its proposed amend-
ments to the CEQA Guidelines in April 2009, and the California
Natural Resources Agency subsequently completed its formal rule-
making process after revising those proposals.

A number of key amended provisions will have significant impli-
cations for the environmental review of proposed projects. First, the
Proposed CEQA Guidelines call for lead agencies to “make a good-
faith effort, based to the extent possible on scientific and factual data,
to describe, calculate or estimate the amount of greenhouse gas emis-
sions resulting from a project.” This provision thus creates a mandate
to incorporate climate change into CEQA review. Lead agencies
may exercise discretion in selecting the appropriate methodology
for making GHG determinations, including whether they will rely on
qualitative analyses. However, Proposed CEQA Guidelines Section
15064.7(c) encourages the development of common environmental
standards across government agencies. It will permit agencies to
“consider thresholds of significance previously adopted or recom-
ended by other public agencies” as long as those thresholds are “support-
based by substantial evidence.”

Projects that are consistent with an agency’s previously adopted
GHG emission reduction requirements—as set forth in a land use plan,
policy, or regulation for which an EIR was already certified—may not
require additional environmental review under the Proposed CEQA
Guidelines. They also permit agencies to evaluate GHG emissions at
a “programmatic level” (for example, a general plan) and to rely
on that analysis, through “tiering” or incorporating by reference, for
the environmental review of project-specific effects.

The Proposed CEQA Guidelines also highlight a few explicit
avenues for mitigating GHG emissions. These include off-site carbon
offsets, GHG sequestration, use of alternate and renewable fuels, and
resource efficiency measures. Further, the Proposed CEQA Guidelines
expand the scope of the analysis for an agency seeking to adopt a
Statement of Overriding Considerations by allowing the agency to bal-
ance “region-wide or statewide environmental benefits of a pro-
posed project against its unavoidable environmental risks.”

Even prior to the adoption of the final revised CEQA Guidelines,
some agencies have begun the process of developing thresholds of sig-
nificance for greenhouse gas emissions. For example, in September
2009, the Bay Area Air Quality District published Draft Guidelines
that establish a threshold of 1,100 metric tons per year of carbon diox-
ide emissions for land use projects. Thus any project generating annual
carbon dioxide emissions in excess of this standard is presumed to “result
in a cumulatively considerable contribu-
tion of GHG emissions and a cumu-
latively significant impact to global cli-
mate change.” The Proposed CEQA
Guidelines encourage agencies to rely
on thresholds of significance adopted
by other jurisdictions, so this type of
standard will likely proliferate.

Trial courts have referred to an ear-
lier document published in January
2008 by the California Air Pollution
Control Officers Association (CAP-
COA). The intent of CAPCOA’s white
paper, CEQA and Climate Change: Evaluating and Addressing Greenhouse
Gas Emissions from Projects Subject to
the California Environmental Quality
Act, was to “serve as a resource for
public agencies as they establish agency
procedures for reviewing GHG emis-
sions from projects under CEQA.” It
discusses varying approaches to estab-
lishing significance thresholds, analy-
tical tools for evaluating project-specific and planning-level GHG
emissions, and effective mitigation measures.

Litigation and GHG Analysis
Initially, in the absence of clear direction from the legislature, envi-
ronmental advocacy organizations and the California Office of the
Attorney General sought to reform CEQA through litigation. Although
there are no published appellate decisions addressing the issue of
whether CEQA requires analysis of GHG emissions, recent trial court
decisions illustrate a growing trend requiring analysis of the envi-
ronmental impact of projects on climate change resulting from GHG
emissions.

In a number of early cases, trial courts had rejected petitioners’
claims that CEQA required analysis of GHG emissions. In Natural
Resources Defense Council v. Reclamation Board of the Resources
Agency of California, the petitioners argued for additional analy-
sis of new information involving the impact of climate change on the
Sacramento-San Joaquin Delta. This information became available
after the certification of a Supplemental EIR. The superior court
rejected the claim, finding that the existence of climate change was
generally known and understood when the EIR was initially prepared
and that the new information presented by the petitioners was not
sufficiently specific to the proposed project. Similarly, in American
Canyon Community United for Responsible Growth v. City of
American Canyon, the trial court held that the adoption of AB 32 did
not constitute “new information” warranting the preparation of a new
EIR for a proposed Wal-Mart Super Center.

In other cases, courts found that the analysis of a project’s impact
on global climate change was too speculative. Under CEQA, the lead agency must only evaluate the significance of direct physical environmental effects and the “reasonably foreseeable” indirect physical changes caused by a project. Speculative changes are not reasonably foreseeable and therefore need not be analyzed. In addition, when a lead agency finds, after “thorough investigation,” that the evaluation of an impact is too speculative, the agency is not responsible for further analysis of it.

On this basis, the trial courts in Center for Biological Diversity v. City of Perris and Santa Clarita Oak Conservancy v. City of Santa Clarita upheld the cities’ determinations that climate change analysis was too speculative in those cases and therefore not required by CEQA. Further, the superior court in Center for Biological Diversity v. County of San Bernardino held that in the absence of express direction from the state, any analysis of a particular project’s impact on climate change as a global phenomenon would also be too speculative. Moreover, in Westfield, LLC v. City of Arcadia, the superior court found that an individual retail development could not have a significant impact on global climate change. Finally, in Highland Springs Conference and Training Center v. City of Banning, the trial court rejected the petitioners’ claim that CEQA mandates an analysis of GHG emissions. The court stated simply that “no law required the Banning City Council to consider global warming at the time it approved the project.”

Recently, however, some trial courts have begun to find that CEQA actually does require analysis of a project’s environmental impact regarding climate change. For example, in Natural Resources Defense Council v. South Coast Air Quality Management District, the superior court found that the agency’s environmental review was inadequate because the GHG emissions analysis only included an evaluation of carbon dioxide emissions.

Two other cases may indicate that the pendulum has swung toward requiring more expansive environmental analysis. In Center for Biological Diversity v. City of Desert Hot Springs, the trial court rejected the city’s claim that the evaluation of a project’s impact on global climate change was too speculative, even if regulatory agencies have yet to endorse a framework for analysis. Further, in Coalition for Environmental Integrity in Yucca Valley v. Town of Yucca Valley, the superior court granted a petition for writ of mandate ordering the town to revise an EIR because it “simply ignores the CAPCOA scientific and factual analysis regarding attainment of California GHG emission targets in its discussion of the cumulative impact of the Project.”

Following on these courtroom successes by project opponents, the Center for Biological Diversity is seeking to use CEQA to stop or delay a logging project. In August 2009 the center filed a writ petition to overturn the California Department of Forestry and Fire Protection’s approval of a timber harvest plan submitted by Sierra Pacific Industries. The petitioners are alleging that the California Department of Forestry and Fire Protection did not adequately analyze the cumulative, site-specific GHG emission effects associated with the proposal by Sierra Pacific Industries to harvest 431 acres of timber. The writ asserts that “[i]n passing Senate Bill 97 (2007), the State of California explicitly recognized that greenhouse gas emissions are an important environmental issue, requiring analysis under CEQA.” The petitioners claim that Sierra Pacific improperly evaluated GHG emissions based on all the company’s properties rather than the specific logging site under consideration.

The California Attorney General’s Office also has been actively involved in the policy debate regarding whether CEQA requires an analysis of a project’s impact on climate change. As early as 2006, former Attorney General Bill Lockyer submitted formal comment letters to the Orange County Transportation Authority and the San Bernardino Land Use Services Department that CEQA required the EIRs for their respective plans to contain discussions of climate change. Attorney General Jerry Brown has submitted more than 40 such letters to local governments and regional agencies regarding major projects and plan revisions. In addition to arguing that the EIRs must evaluate climate change, the attorney general’s comment letters have highlighted specific measures—such as the promotion of urban infill and transit-oriented development, the adoption of green building ordinances, and the like—to mitigate GHG emission impacts.

Based on a broad interpretation of the legislative intent behind AB 32, Attorney General Brown brought suit against San Bernardino County in April 2007, alleging the county’s General Plan Update violated CEQA by “not adequately analyze[ing] the adverse effects of implementation of the General Plan Update on air quality and climate change and did not adopt feasible mitigation measures to minimize the adverse effects of implementation of the General Plan Update on climate change and air quality.” The Attorney General’s Office and San Bernardino County eventually settled the case, with the county agreeing to a number of conditions. These included 1) amending the General Plan to add reduction of GHG emissions “reasonably attributable to the County’s discretionary land use decisions,” 2) preparing a GHG Emissions Reduction Plan, and 3) conducting environmental review, pursuant to the requirements of CEQA, on both the General Plan Amendment and the GHG Emissions Reduction Plan.

Despite these legislative, regulatory, and case law developments, no bright-lines rules have emerged. How should project developers proceed to minimize the risk that agency approvals will be subject to costly delays or potentially overturned in court, based on inadequate CEQA analysis regarding climate change?

CEQA already requires extensive environmental analysis. Project developers, sponsors, investors, and lenders have built-in expectations regarding the costly and time-consuming entitlement and CEQA compliance process in California. Going forward, they can expect that environmental reviews under CEQA in the area of GHG emissions and mitigation will require increased quantification to survive regulatory scrutiny and the inevitable legal challenges. Environmental consultants and other technical professionals are developing increasingly refined analytical models to estimate a project’s impact on climate change.

Of course, a number of project-specific issues will need to be addressed. Many proposed projects simply shift emissions from one location to another. For example, a new shopping center that attracts customers away from an aging existing retail center may do little more than swap vehicle-trips rather than generate a net increase in transportation-related emissions. Therefore, project proponents must evaluate new environmental effects, if any, on the basis of regional emissions. Existing conditions must be properly accounted for as a baseline against which new environmental effects may be evaluated.

Air quality management districts as well as other local or regional agencies will likely adopt thresholds of significance for GHG in the near future. Because the Proposed CEQA Guidelines expressly permit lead agencies to rely on thresholds of significance adopted by other jurisdictions, there will likely emerge some standardization and predictability for projects of a certain size and scale. Once state and local agencies adopt the applicable thresholds of significance, CEQA analysis may become relatively straightforward based on a pro forma set of calculations.

Mitigation also must be addressed. The CAPCOA white paper identifies and provides details for a number of mitigation measures aimed at reducing GHG emissions for a development project. For example, in order to lessen transportation-related GHG emissions, the CAPCOA white paper suggests enhancing alternative transportation infrastructures and facilities, including locating

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and orienting facilities to support requirements for public transit and reduced parking. The white paper also identifies a host of construction and design-related mitigation measures, such as alternative building materials and improvements in building systems. Project proponents may choose to adopt the white paper’s suggested off-site mitigation fee program, in which a project developer pays into a fund used to retrofit existing buildings or facilities. Alternatively, the white paper suggests an offset program, in which a developer preserves or enhances some resource off-site—typically through the purchase of a credit—that reduces the presence of GHG in the atmosphere.

In the interim, to the extent possible given fluctuating market conditions, developers should avoid, whenever possible, seeking new discretionary entitlements that will open the door for additional CEQA review. If the project must undergo minor changes, proponents can prepare an EIR addendum for which public circulation is not required. This is a challenging time for project developers. They should heed the undeniable trend toward requirements for more comprehensive and detailed analysis of GHG emissions for proposed development projects. Once the Proposed CEQA Guidelines are adopted, additional litigation will follow, leading to court decisions interpreting and refining CEQA’s mandates. Given their fiscal challenges, local governments will likely take a number of years to fully update their long-range planning documents to incorporate GHG analysis consistent with state law mandates.

Therefore, in the short term, individual developers face the prospect of proactively evaluating the environmental impact of GHG emissions on a project-by-project basis. To protect themselves against the cost and delay of meritorious CEQA challenges, proponents should take a comprehensive approach to GHG analysis during the environmental review period. At the same time, they should think creatively about incorporating effective, cost-efficient mitigation measures into their projects.

3 42 U.S.C. §§4321 et seq.
4 Subject to certain requirements, SB 1185 and AB 333 extend the duration of some existing and unexpired

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tentative subdivision maps, parcel maps, and related administrative approvals that would have otherwise expired prior to January 1, 2011.

5 While the issue of what constitutes a “project” under CEQA is the subject of numerous court decisions, the determining factor is the discretion of a government agency to approve or deny the project. Thus, purely administrative decisions (such as the issuance of a building permit) are exempt from CEQA, while discretionary approvals (conditional use permits, subdivisions, and the like) fall within the scope of CEQA review.


8 CEQA Guidelines §15070.

9 CEQA Guidelines §15064.

10 CEQA Guidelines §15064(a)(1).

11 CEQA Guidelines §15126.4.

12 Prop. CEQA Guidelines §15064.4.


14 CEQA Guidelines §15162(a).

15 Id.

16 HEALTH & SAFETY CODE §§38500-38599.

17 HEALTH & SAFETY CODE §38501(a).

18 PUB. RES. CODE §21083.05.

19 See http://ceres.ca.gov/ceqa/guidelines/.

20 Prop. CEQA Guidelines §15064.4.

21 Prop. CEQA Guidelines §15183.

22 Prop. CEQA Guidelines §15183.5.

23 Prop. CEQA Guidelines §15126.4(c).

24 Prop. CEQA Guidelines §15093(a).


27 See Pub. Res. Code §21166. This section dictates when the availability of new information requires the preparation of a new EIR.


29 CEQA Guidelines §15064(d).1.

30 CEQA Guidelines §15064(d)(3).

31 CEQA Guidelines §15145.

32 Center for Biological Diversity v. City of Perris, No. RIC 477632 (Super. Ct. Riverside County, Aug. 9, 2007).


34 Center for Biological Diversity v. County of San Bernardino, No SS 0700293 (Super. Ct. San Bernardino County, Apr. 2008).


38 Center for Biological Diversity v. City of Desert Hot Springs, No. RIC 464856 (Super. Ct. Riverside County, Aug. 6, 2008).


41 Prop. CEQA Guidelines §15964.7(c).

42 CEQA Guidelines §15164.
ALL TOO FREQUENTLY in today’s depressed real estate economy, developers attempting to build and sell condominiums are finding their projects derailed by a lack of buyers. “Broken condominium projects” are those projects in which some units have been sold and the homeowners have an operating homeowners association, but the original developer is unable to complete sales of all the units. To complicate matters, the most recent real estate boom fueled significant speculation in condominium construction and conversion, and the reality of the current condominium market is that more and more broken condominium projects are changing hands. The successor owners of these projects generally are lenders, who acquire the property through foreclosure, or third-party bulk purchasers, who acquire the property under bulk sale contracts.¹

Acquiring broken condominium projects requires a multifaceted due diligence process. It should include an analysis of a broad range of issues involving resales of the property (including statutorily required public reports), owners associations, and developer’s rights. However, the most important of the potential issues to be analyzed often is the extent of the potential construction defect liabilities that a successor owner may acquire along with the broken condominium project.

If the construction defect liabilities are extensive and the acquiring party will be the only entity responding to those liabilities, and if there is no statutory or other protections to assert against claims of liability, the acquiring party may decide that it is not advisable to proceed. However, if the liabil-

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ties can be limited or managed or are not the sole responsibility of the acquiring party, the acquisition may be feasible. Identifying the liabilities and developing a strategy to address them may overcome any barriers to acquisition and will be an essential part of the due diligence process.

The most significant factors affecting construction defect liability are 1) the construction, if any, to be completed by a successor owner, 2) whether a successor owner plans to engage in retail sales, and 3) the amount of time that a successor owner plans to hold the property. This last factor must be assessed along with any actions that a successor owner does or does not take during that period regarding maintenance, management, or governance of the project. A successor owner needs to discern 1) the likelihood of construction defect liability, 2) whether the owner will need to make payments to cover any shortfall in assessments or association funds, 3) prospective liability for maintenance, management, or operation of the property, 4) what funds may be available to address potential liabilities, and 5) what additional options may be available to protect against liabilities going forward. Even after the acquisition takes place, actions may still be required to mitigate the risks inherent in a broken condominium project.

In some cases, a foreclosing lender will have some protection from these potential liabilities under statutory and case law. Under other circumstances, the exposure will be the same whether a successor owner is a foreclosing lender or a bulk purchaser. The extent of liability exposure for successor owners ultimately will depend on the nature of their involvement with the property as well as whether they are a foreclosing lender or a bulk purchaser.

Homeowners associations have standing to sue on behalf of multiple owners. As a result, attached residential condominium structures are frequently the target of construction defect claims, whether spurious or legitimate. A broken condominium project may be even more vulnerable to such claims, since it may have suffered from neglect in a variety of ways. Once a project is in trouble, construction funds may be reduced, homeowners associations may be underfunded (which may lead to improper or nonexistent maintenance), assessments may become delinquent, existing construction defects may not be addressed, and reserves may be underfunded. All of this could lead to the accelerated deterioration of the project and a concurrent increase in liabilities.

**Civil Code Section 3434 and SB 800**

Many construction lenders assume that, after foreclosure, they are protected from liability for construction defects caused by the developer. They claim the protection of Civil Code Section 3434, which provides that a construction lender is not liable for construction defects under certain circumstances. However, this protection is limited, so lenders need to be alert to circumstances that may fall outside its reach.

Section 3434 provides protection to a lender “unless the loss or damage is a result of an act of the lender outside the scope of the activities of a lender of money.” The section does not specify whether the lender is acting outside the scope of the activities of a lender once it has foreclosed and is in possession of the property. It also does not address what, if any, postforeclosure actions constitute acting outside the scope of the activities of a lender.

Typically, a lender who forecloses may be required to assume additional obligations and responsibilities as soon as the foreclosure occurs. For example, it may need to serve on the board of an owners association, engage in the operation of the project, or market and sell the units to the public. In conducting any of these activities, whether the lender acts outside the scope of the activities of a lender is likely to be analyzed as a continuum rather than according to a bright-line test. The longer the lender holds the property, and the more involved the lender becomes in construction, development, management, operation, and maintenance of the property, the more likely that the lender will lose the protection of the statute. While these activities do not automatically exclude a lender from the liability protections of the statute, the lender is advised to conduct these activities in ways that are consistent with protecting its security interest and disposing of collateral.

Many lenders who know that significant involvement in the project is necessary before letting it go will either 1) acquire the project as a single purpose (or special purpose) entity (SPE) to limit their liability exposure to the value of the property they acquire or 2) seek the appointment of a receiver to operate the project while sorting out liabilities and an exit strategy. Provided that the lender is not controlling the activities of the receiver, the lender will be protected by Section 3434 during the receivership, because the lender is not doing anything inconsistent with lending activities. The lender should exercise caution in limiting its involvement in the project so that the lender always stays within the scope of the activities of a lender.

If the property is “original construction,” bulk purchasers—as well as lenders who engage in retail sales and are not protected under Civil Code Section 3434—may be liable for construction defects under the California Right to Repair Law, commonly referred to as SB 800. They may also be liable under common law if the property is a condominium conversion or if SB 800 is found not to apply to the successor owner of original construction. Common law principles also may come into play if the successor owner has not engaged in direct retail sales.

For construction defects associated with existing or previously owned property and unknown to the seller, the seller is generally not liable under an implied warranty for the defects. According to case law, “The doctrine of implied warranty in a sales contract is based on the actual and presumed knowledge of the seller, reliance on the seller’s skill or judgment, and the ordinary expectations of the parties.” However, no California case has directly addressed the application of SB 800 or common law to foreclosing lenders or bulk purchasers. In other jurisdictions, when the lender or bulk purchaser has no involvement in any construction on the property, courts have been reluctant to impose liability for construction defects under common law.

To help minimize liability, lenders engaging in retail sales of foreclosed property should specifically disclose that the property is sold in its “as-is” condition. In addition, lenders should disclose if they did not perform any construction on the project. If they did engage in construction, they should list the particular improvements they made in order to define the scope of any potential liability. Lenders should also craft a recital as part of the sale. It should state that they are selling the property to recover the value of loans secured by the property and they are not in the business of constructing or selling residential units for retail purposes.

These steps should be taken if the successor owner has undertaken no work at the property or only protective actions (such as securing the property against vandalism) or minor decorating. If, however, lenders or bulk purchasers are required to do construction work to complete or renovate an existing project before they can market the property, they should evaluate their attendant liability exposure. Again, California courts have not directly addressed this issue, but decisions from other states have found foreclosing lenders liable for performance of express representations to buyers, for patent construction defects in the entire project, and for breach of any applicable warranties regarding the work performed by the lenders. Thus, whenever possible, successor owners should refrain from performing construction work to complete a project. Options to construction include seeking the appoint-
Successor owners that hold the common area of a broken condominium project will not have any liability exposure for construction defects.

True.
False.

One of the most significant factors affecting construction defect liability for successor owners is whether they engage in retail sales.

True.
False.

A broken condominium project may be uninsured even if it is under a wrap insurance program, because the program’s limits may be exhausted by other projects covered by the same program.

True.
False.

If the developer chose to opt in to the provisions of SB 800, the successor owner will be required to do so as well.

True.
False.

A receiver’s liabilities are the same as those for a successor owner of a broken condominium project.

True.
False.

The purpose of forming a single purpose entity to foreclose on property in place of the original lender is to limit postforeclosure liability to the assets of the SPE.

True.
False.

Civil Code Section 2782 limits express contractual indemnities provided from subcontractors to the contractor.

True.
False.

A condominium project is designated as “broken” when it lacks a homeowners association.

True.
False.

“Hold and wait” is often the best investment strategy for a broken condominium project.

True.
False.

The successor owner of a broken condominium conversion is not liable under SB 800 for construction defects.

True.
False.

The California Court of Appeal has ruled that SB 800 applies to foreclosing lenders and bulk purchasers.

True.
False.

Civil Code Section 3434 provides protection for lenders from construction defect claims even after lenders foreclose and take possession of a property.

True.
False.

Potential construction defect liability is only one of several risks to be evaluated in deciding whether to purchase a broken condominium project.

True.
False.

Civil Code Section 3434 provides protection for conversion.

True.
False.

A wrap insurance program purchased by a developer to cover its construction defect liability will transfer automatically to the successor owner because the insurance is intended to cover all construction on the project until the expiration of the statute of limitations.

True.
False.

Lenders who seek the appointment of a receiver to manage their broken condominium projects while they devise their exit strategies can limit their liability by directing the receiver’s day-to-day activities.

True.
False.

If a foreclosing lender did not perform any construction work on the project, it may still have liability as a “builder” under SB 800.

True.
False.

Future reference, please retain the MCLE test materials returned to you.

True.
False.

If the developer chose to opt in to the provisions of SB 800, the successor owner will be required to do so as well.

True.
False.

Successor owners of broken condominium projects that do not perform construction work on their projects will not have any liability exposure for construction defects.

True.
False.

A receiver’s liabilities are the same as those for a successor owner of a broken condominium project.

True.
False.

Successor owners that hold the common area of a project for several months may shield themselves from liability for maintenance and management if they do not participate on the board of directors of the homeowners association and in the operation of the property.

True.
False.

A broken condominium project may be uninsured because the insurance is intended to cover all construction on the project.

True.
False.

To cover its construction defect liability will transfer automatically to the successor owner because the insurance is intended to cover all construction on the project.

True.
False.

IF A FORECLOSING LENDER DID NOT PERFORM ANY CONSTRUCTION WORK ON THE PROJECT, IT MAY STILL HAVE LIABILITY AS A “BUILDER” UNDER SB 800.

True.
False.

In the operation of the property.

True.
False.
To help minimize liability, lenders engaging in retail sales of foreclosed property should specifically disclose that the property is sold in its “as-is” condition. In addition, lenders should disclose if they did not perform any construction on the project. If they did engage in construction, they should list the particular improvements they made in order to define the scope of any potential liability.

In the majority of situations, at least a potential for construction defect liability will exist even though actual liabilities have not yet materialized. However, identifying potential or actual liability is not the end of the inquiry. Successor owners also must evaluate the extent of their exposure, whether they can protect themselves either by the appointment of a receiver or by the manner in which they

lender acquires property for resale to a bulk purchaser, without performing any construction prior to the resale, the acquiring party does not appear to fall within the definition of a “builder” in SB 800. However, when acquiring new construction with the intent of engaging in retail sales now or in the future, the lender will need to consider whether it has builder obligations and liabilities under SB 800. The definition of “builder” under the statute includes the “original seller...in the business of selling residential units to the public.” Further, the statute applies to “original construction intended to be sold as an individual dwelling unit.” SB 800 does not define “original construction,” but lenders may argue that, for the acquiring entity, the project is not “new” or “original” construction, and the successor entity is not necessarily “in the business of selling residential units to the public.” Until the law is settled in this area, the safer approach for successor owners is to assume that SB 800 could be applied to the acquiring entity as the seller of “original construction” and assure compliance with the statute while specifying that such compliance is not an admission of the applicability of the statute.

In complying with the statute, successor owners should make their own decisions regarding whether to opt in or opt out of the nonadversarial provisions of SB 800. These provisions establish an optional nonlitigation path for resolution of construction defect claims. Successor owners should make this decision carefully since the approach taken by the original developer may not apply or may make compliance difficult for any successor owner. For example, the original developer may have opted out of the statutory nonadversarial provisions in favor of procedures dictated by its insurer and, in connection with its insurance requirements, issued a warranty

whether it has builder obligations and liabilities under SB 800. The definition of “builder” under the statute includes the “original seller...in the business of selling residential units to the public.” Further, the statute applies to “original construction intended to be sold as an individual dwelling unit.” SB 800 does not define “original construction,” but lenders may argue that, for the acquiring entity, the project is not “new” or “original” construction, and the successor entity is not necessarily “in the business of selling residential units to the public.” Until the law is settled in this area, the safer approach for successor owners is to assume that SB 800 could be applied to the acquiring entity as the seller of “original construction” and assure compliance with the statute while specifying that such compliance is not an admission of the applicability of the statute.

In complying with the statute, successor owners should make their own decisions regarding whether to opt in or opt out of the nonadversarial provisions of SB 800. These provisions establish an optional nonlitigation path for resolution of construction defect provided by the insurer that did not also insure the successor owner. In this situation, there is no reason for the successor owner to adopt the same approach. Similarly, if the original developer opted into the statutory nonadversarial provisions, the successor owner needs to independently evaluate whether it will be able to comply given that it may not have access to construction documents that it may need to produce to a claimant on relatively short notice. If SB 800 is applicable, the successor owner is subject to strict construction defect liability for the project’s failure to meet the functionality standards and may be liable for obligations of the minimum fit and finish warranty required by the statute.

Although SB 800 liability cannot be waived if it does apply, the successor owner should consider a provision in its sales agreements that if SB 800 does not apply to the project, the acquiring entity disclaims responsibility for the original construction and acknowledges that the property is sold in its as-is condition. Even if successor owners engage in retail sales but do not consider themselves to be governed by SB 800, they will need to decide whether to provide a fit and finish warranty or some other express warranty to buyers to avoid the warranty being “implied” under the statute. Whether the property is sold as is or subject to some type of express warranty, the purchase agreement should contain a waiver of implied warranties.

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California in lieu of separate policies for each party. This is because wrap insurance can reduce the overwhelming litigation costs associated with multiple insurers on a single project. Each wrap insurance program must be evaluated individually as to whether it is likely to provide any meaningful insurance coverage once the developer is no longer in the picture.

The fundamental analysis of any liability insurance involves identifying the policy limits. With wrap insurance, the available limits will depend on the scope of the program. For example, if a wrap insurance program covers multiple projects, the entire limits of liability may be eroded by a single project, leaving others under the same program virtually uninsured. The determination of available policy limits does not end with the total limits of liability per occurrence and in the aggregate but also encompasses all out-of-pocket costs to the developer or other insureds. Included in this calculation should be the amount of the self-insured retention or deductible and whether the cost of defending litigation is in addition to the stated limits of liability or is included within the stated limits.20

Part of the policy review will involve determining who is insured under the policy either as a named insured or as an additional insured. Typically, lenders will require that they be named as an additional insured under the contractor’s liability policies. The term “additional insured” describes a party added to the coverage of the policy by endorsement. However, the endorsement creating this status also may contain coverage limitations. As an additional insured, a lender may not have coverage for completed operations, which typically is the coverage that applies to construction defect claims. At a minimum, the additional insured endorsement for a lender will typically exclude any alterations, construction, or demolition by the lender. Therefore, lenders generally will require separate insurance if they perform any work at the project.21

However, even if the insurance includes the lender, wrap insurance policies carry a number of ongoing obligations that the developer may or may not have met, particularly with a distressed asset. If the lender is named in the developer’s liability insurance policy, the lender will have to explore whether coverage was properly maintained by the developer and whether the developer’s insurer contends that the insurance was compromised either by the developer’s conduct prior to the foreclosure or as a result of the foreclosure. If the lender is not directly covered under the developer’s policy, the lender should explore whether it can be added to the policy and continue with it after the foreclosure.

Another likely obligation of wrap insurance is that each subcontractor meet certain qualifications and complete an application form. Subcontractors that did not qualify for the wrap insurance program may have provided evidence of insurance and performed work on the project with independent coverage—despite the fact that the bulk of the project was covered by a wrap program. If so, the acquiring entity should also explore the additional policies that may exist apart from the wrap program.

Additionally, the norm for the past decade for any construction insurer in California is to require the developer to implement quality control measures in order to monitor the project as it progresses and make recommendations to minimize liability. In those projects that have encountered financial trouble, the developers may not have followed the quality control measures required by the insurer. This failure may be grounds for a denial of coverage when claims materialize.

Any investigation regarding potential insurance coverage must include a review of the specific policy language applicable to the project in question. Most often, wrap insurance programs are built upon the same basic general liability policy forms as traditional liability insurance. Endorsements added to the program can change—or even obliterate—this coverage.22 Any assumptions about what may be covered are unreliable without a review of the entire policy. Successor owners should engage an attorney, agent, and/or broker experienced in construction liability insurance coverage to make this analysis. Insurance coverage issues may be obvious in some cases but more often they are esoteric, counterintuitive, or obscure.23

Many wrap insurance programs do not include design professionals, who most likely have separate errors and omissions coverage. Depending on the anticipated liabilities that the successor owner has identified for the project, these policies may be significant. However, unlike insurance issued directly to the developer, design professionals should not be expected to name the lender as an additional insured. For that reason, these policies cannot be considered as a source of funds directly available to the successor owner but rather as an additional pool of money that may be available to cover claims.

Insurance maintained by the existing homeowners association may provide another source of funds to cover potential liabilities. The association’s property insurance policy may cover claims arising from a problem caused or exacerbated by the association’s failure to maintain a component. Similarly, if the statute of limitations has run for a claim against the developer, the association may
become the primary entity responsible for damages within the project. The acquiring entity should obtain and review copies of the association’s liability insurance, property insurance, and directors and officers insurance policies.

A single homeowner in an attached condominium project has the potential to cause damage to multiple units. Thus many projects now contain requirements in their governing documents that individual homeowners maintain liability insurance in specified minimum amounts. Even in the absence of a requirement, an individual homeowner may obtain liability insurance, which will only become a factor when the damage for which the successor owner is sued was either caused or exacerbated by the homeowner’s conduct.

Reviewing the governing documents to ascertain the insurance requirements imposed upon the project’s homeowners will at least allow the successor owner to assess the likelihood that an individual homeowner (or the homeowner’s insurer) will be in a position to bear a share of any damage to the project.

Even when liability insurance is ostensibly available to the project either through the developer or some other source, whether that insurance will actually cover a particular claim cannot be tested until the claim is asserted. Successor owners who have done their investigatory homework and uncovered the existence of insurance may find that the policies offer false hope. For this reason, successor owners should consider the option of obtaining their own insurance, which will apply retroactively to the construction that is already in place.

In a wrap insurance program, the contractor and subcontractors generally will have waived any claims against each other to the extent that they are covered under the program. However, if there is a large deductible or self-insured retention, the contractor and subcontractors may have reserved the right to seek indemnity against each other for those amounts. Also, successor owners may have indemnity and/or subrogation rights if a project is insured by traditional insurance—with each party insured under its own general liability policy—or if some of the subcontractors are ineligible for the program and are insured independently. To determine whether the contractor, subcontractors, or their insurers may be a source of contribution to any construction defect liabilities, successor owners should review the construction contracts and subcontracts. If the contract review reveals the potential for indemnity from these parties, any indemnity agreements must be further analyzed to confirm that they are enforceable in light of recent California legislation restricting the circumstances under which a
Completing Construction

Acquisition of an incomplete project presents additional challenges. Successor owners may choose to enhance the value of their projects and take on any possible risks by completing construction themselves for a bulk resale or for retail sales. Alternatively, they may choose the safe route of not completing construction and simply conducting a bulk resale. Another option is to look at potential exit strategies as part of a continuum. By doing so, successor owners can seek mechanisms for limiting liability at various levels of construction.

The purpose of forming an SPE to foreclose on property in place of the original lender is to limit postforeclosure liability to the assets of the SPE. Ideally, the SPE should succeed to the rights and obligations of the original lender and thus have whatever statutory protection may be available to the lender under Civil Code Section 3434. To do so, the lender should transfer the loan and all related documentation, rights, and obligations to the SPE prior to the foreclosure, so that the SPE is effectively the lender at the time of foreclosure. With regard to both common law and SB 800 liability for construction defects, the analysis should be same for the SPE as it is for an original lender. The SPE also must take appropriate precautions to maintain its separateness from the original lender to protect against ultra vires claims or claims alleging that the corporate veil has been pierced.

Risk assessment and risk management can minimize the element of surprise in the acquisition of a broken condominium project. This is particularly true regarding construction defects. While not all issues regarding potential liability have been settled, any lender or bulk purchaser considering whether to pick up the pieces of a broken condominium project should identify any potential problems that could lead to exposure and the extent to which they can be mitigated or eliminated.

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1 Some broken condominium projects will involve court-appointed receivers, whose liabilities are different from those of successor owners because receivers act at the direction of the court. See Andrea C. Chang, Giving and Receiving, Los Angeles Lawyer, Dec. 2009, at 22.
3 Civ. Code §3434.
4 However, there is some precedent in other areas of the law for the idea that merely foreclosing and becoming an owner does not by itself cause the loss of lender protections—so long as the lender’s postforeclosure actions continue to be consistent with the protection of its security interest. See, e.g., 42 U.S.C. §9601(20)(A) (creating the so-called security interest exemption for lenders from the otherwise automatic liability under the Comprehensive Environmental Response, Compensation and Liability Act). Of course, this still raises the...
question of when a lender crosses the line of no longer acting in a manner consistent with the protection of its security interest.

3 A bulk sale of units does not present the same risks and liabilities as retail sales, because the risks in bulk sales may be contractually allocated, and bulk sales do not have the same regulatory and disclosure requirements as retail sales. In addition, SB 800, the construction defect law in California (see nn. 6-21, infra, and accompanying text) applies to the builder or the original seller to the public. If the lender is neither the builder nor the original seller, it would not incur strict liability under SB 800 for construction defects. See Civ. Code § 911. However, to the extent that the foreclosing lender engages in some construction activity to resell the project, it could risk construction defect exposure under common law. See text, infra.

4 Civ. Code §§895-945.5.

5 Civ. Code § 896.


7 20 A.L.R. 5th 499, at 1.

8 Chotka v. Fidelco Growth Investors, 383 So. 2d 1169, 1170 (1980); see also Port Sewall Harbor & Tennis Club Owners Ass’n, Inc. v. First Fed. Sav. & Loan Ass’n of Martin County, 463 So. 2d 530, 532 (1985) (reaffirmed limit to foreclosing lender’s liability). Similarly, the Supreme Court of South Carolina decided in 1994 that a lender who marketed newly constructed units following its purchase of the units from the builder but did not participate in the original construction was only liable to purchasers for negligence related to the repairs it performed. Roundtree Villas Ass’n, Inc. v. 4701 Kings Corp., 282 S.C. 415 (1984). However, more recently, the Supreme Court of South Carolina extended a foreclosing lender’s potential liability to include defects resulting from the original developer’s construction through a theory of implied warranty. The ruling was premised on the fact that the lender became substantially involved in completion of the home, beyond the normal practices of a lender. Kirkman v. Parex, 369 S.C. 477 (2006).

9 SB 800 applies only to residential sales to the public, not to a foreclosing lender who engages in a bulk sale to a third party. Civ. Code § 911.

10 Id.

11 Civ. Code § 896.

12 Civ. Code §§914 et seq.

13 Civ. Code § 912. Successor owners should make every effort to obtain complete construction documents and insurance files from the developer at the earliest time possible in the transaction rather than waiting until a claim arises.

14 Civ. Code § 896. The minimum standards required for new construction apply to potential water intrusion, structural integrity, soils, fire protection, plumbing and sewer, and electrical matters, among others.


16 Civ. Code §896. If the insurance program provides for defense costs in addition to the liability limits of a $3 million general liability policy, the insurer could spend $1.5 million in defending construction defect litigation, but $3 million in coverage would still remain to satisfy claims. If, under the same scenario, defense costs are “within limits,” only $1.5 million would remain for claims. Because of the high cost of construction defect litigation, if the defense costs are within limits, the full amount of coverage may be exhausted by the payment of those costs, leaving nothing for repair or replacement of the defective building component.


19 If the insurance program provides for defense costs in addition to the liability limits of a $3 million general liability policy, the insurer could spend $1.5 million in defending construction defect litigation, but $3 million in coverage would still remain to satisfy claims. If, under the same scenario, defense costs are “within limits,” only $1.5 million would remain for claims. Because of the high cost of construction defect litigation, if the defense costs are within limits, the full amount of coverage may be exhausted by the payment of those costs, leaving nothing for repair or replacement of the defective building component.

20 A typical precautionary step is to include the developer’s rights in any existing insurance coverage as part of the assets upon which the lender is foreclosing. Similarly, the bulk purchaser should seek an assignment of those rights as part of its acquisition of the project. These actions are particularly helpful when any party’s policies cannot be located or if the successor owners question whether the policies they have obtained are complete.

21 Some developers have had the unpleasant surprise of discovering that a wrap insurance program purchased for a condominium project does not cover multifamily construction.

22 With the use of standardized policy forms so prevalent, courts in various jurisdictions have interpreted the same policy language in different contexts. Thus, dozens of courts in many states have analyzed the meaning of a commonly used term such as “sudden.”

23 If existing insurance can be confirmed and if the successor owner is either covered or can obtain coverage under the insurance, there are advantages to doing so. For instance, having a single insurer covering all construction defect claims at the project eliminates the conflict between multiple insurers regarding whose coverage applies in the event of a loss.

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AS REAL ESTATE VALUES continue to decline and capital markets remained challenged, an increasing number of borrowers are facing defaults on their commercial real estate loans. While loan modifications, workouts, and lender’s remedies are familiar areas to lawyers with experience in prior real estate cycles, a new aspect of the current downturn has been the impact of securitization on the handling of distressed debt.

Securitization was widely used in commercial real estate financing in the years leading up to the current downturn. It is believed that there are close to $714 billion in outstanding commercial real estate loans that are securitized into commercial mortgage-backed securities (CMBS). In September 2009, the monthly delinquency for CMBS increased to $31.73 billion, up 583 percent from one year before, when only $4.64 billion of delinquent balance was reported. This amount is now over 14 times the low point of $2.21 billion in March 2007.

Securitization presents unique challenges to working out a commercial real estate loan. Dealing in distress in the context of a CMBS loan requires an understanding of the real estate mortgage investment conduit (REMIC) rules, how the rating process works, the standard terms of a pooling and servicing agreement (PSA), how to work with special servicers, and the limitations imposed upon special servicers. These challenges may be addressed with some practical tips to assist commercial borrowers with CMBS workouts.

Similar to securitized credit card receivables and auto loans, CMBS are based on a simple principle. A lender (which may be an insurance company, bank, hedge fund, or some other mortgage originator) makes a group of loans. In the case of CMBS, those loans have to satisfy certain criteria in order to obtain the highest ratings by the rating agencies. The criteria include limitations on debt-to-equity ratios, obligations to maintain operating expense and leasing cost.

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reserves, and a requirement that the borrower be a newly formed special purpose entity operated in a manner that is designed to avoid substantive consolidation (if there was a bankruptcy of a principal caused by losses on other assets). If these conditions are met, the qualifying loans are bundled together into a trust of sorts under a PSA.

Bonds are issued to investors, who receive the repayment of principal and interest on those bonds from the loan payments made by the borrowers of the various loans in the trust. The “lender” (the party who holds the loan) is the trust, and the bondholders’ interests are represented by a loan servicer. The PSA designates the entity that services the pooled loans.

The typical CMBS is populated with mortgages from a diverse group of properties. Unlike its cousin, the residential mortgage-backed security, which usually has thousands of loans in the pool, many large CMBS are backed by fewer than 100 loans in size ranging from a million to several hundred million dollars (a few of some of the more recent vintages tipping over $1 billion).

The Role of CMBS

During the past 15 years, the role of CMBS in commercial real estate financing has steadily increased. Owners of office buildings, shopping centers, hotels, and other commercial properties have become very dependent on CMBS for long-term financing. These loans tend to be attractive to borrowers, offering both fixed and “floater,” or adjustable rate, loans on a nonrecourse basis. With a nonrecourse loan, the borrower is not personally liable for the loan, and the lender agrees to look solely to the real estate collateral for repayment, except for personal liability for certain acts or omissions known as “bad boy” exceptions, such as failure to apply proceeds to pay insurance or real estate taxes. CMBS loans offered price advantages and made large loans (in excess of $300 million) possible. Many CMBS loans would have been very difficult, if not impossible, to underwrite under the traditional banking model.

The downside for a borrower obtaining a CMBS loan includes being unable to readily prepay the loan prior to its stated maturity date. There are usually lock-outs during the first few years as well as obligations regarding defeasance, or yield maintenance, in lieu of prepayment. In addition, many borrowers believe that if they need to modify or clarify the loan terms, they will not receive the same responsiveness from a loan servicer that they would receive from a banker, especially one with whom they have been doing business for many years. In fact, the interface between borrowers and their counsel with master and special servicers may prove to be one of the most challenging aspects of the coming need to work out CMBS loans.

The Credit Crunch and CMBS

The commercial real estate market and CMBS are facing two different kinds of pain today: a significant increase in delinquencies, which for CMBS are about five times higher in 2009 than they were in 2008, and the fact that borrowers are unable to obtain new loans to pay off the maturing loans as they come due. Delinquencies can be attributed to overly aggressive assumptions about vacancy rates and rental growth. The inability to obtain new financing is the result of more conservative underwriting by the “portfolio” lenders (banks and insurance companies), and the fact that the CMBS market is all but closed for new business.

Thus, even those properties that have sufficient cash flow to remain current on debt service payments will be unable to pay off their loans as they mature. According to the most current market statistics, between December 2010 and the end of 2012, almost $175 billion in loans that make up CMBS will be coming due, and it is estimated that some two-thirds of those loans will be unable to be refinanced. The strain on cash flows and the lack of liquidity is putting significant downward pressure on valuations.

Of course, CMBS is not the only type of commercial real estate financing that has a risk of higher defaults in the current economic climate. Banks hold some $1.7 trillion in commercial mortgages and construction loans, of which $335 billion (a few of some of the more recent vintages) is backed by fewer than 100 loans in size ranging from a million to several hundred million dollars (a few of some of the more recent vintages tipping over $1 billion).

As was the case in the residential sector, a negative feedback loop may depress values further and push more loans into default.

CMBS Workouts

When a loan held on the books of a traditional lender goes into default, the bank will either work with the borrower to restructure the loan payments in an effort to bring the loan back into a conforming status, sometimes with a pay-down, additional collateral, or a credit enhancement, or send a formal default notice and begin the exercise of its remedies, such as foreclosure. But what happens when a CMBS loan goes into default?

The formulaic nature of CMBS loans, which made them relatively easy for borrowers to obtain, presents some real challenges when things go bad. CMBS loans are held by scores of bondholders, and there is no lender per se but rather a trust with a loan servicer. Moreover, there can be as many as three different servicers. The “master servicer” has primary responsibility for managing the pool of loans, collecting interest payments, and acting in the capacity as the lender on performing loans. Next, a “subservicer” may have some delegated duties that would otherwise be performed by the master servicer (the loan originators generally try to retain the servicing of the loans that they originated by becoming a subservicer). Third, a “special servicer” will take over from the master servicer when a CMBS loan goes into default. The master servicer generally cannot make any changes to the loan terms. The loan’s file must be on the desk of the special servicer before any loan modification discussions can commence, and the special servicer has primary responsibility for determining how to handle a distressed CMBS loan.

When addressing problems that arise with a commercial loan that has been securitized, the primary challenges include 1) if the loan is not yet in default, satisfying the conditions to getting the loan into the hands of the special servicer, and 2) the limitations on what special servicers can do to modify and work out a loan, given the restrictions imposed primarily by the REMIC provisions of the Internal Revenue Code and by the terms of the PSAs.

REMIC Rules

The Internal Revenue Code provisions on real estate mortgage investment conduits are important because a CMBS trust is exempt from federal taxes at the entity level. Qualification of an entity (including a CMBS trust) as a REMIC requires, among other things, that on the close of the third month after the startup day and at all subsequent times,
“substantially all of its assets consist of qualified mortgages and permitted investments.”

When originally enacted, Congress intended the REMIC provisions to apply only to entities that 1) hold a substantially fixed pool of real estate mortgages and 2) have “no power to vary the composition of [their] mortgage assets.” This latter point is particularly relevant. Under the previous regulations, a “significant modification” of a loan held by a REMIC was deemed to be an exchange of the original debt for a new debt. Therefore, even if an entity originally qualified as a REMIC, one or more significant modifications of loans held by that entity may cause it to lose its REMIC status if the modifications cause “less than substantially all of the entity’s assets to be qualified mortgages.”

Revenue Procedure 2009-45 changes the REMIC rules to broaden the universe of “special servicing transfer events,” which are what allow the servicing of a loan to be transferred to a special servicer. The intent is to create some flexibility to allow borrowers with at-risk or distressed assets securing CMBS loans to ask for help earlier in the path toward default or foreclosure.

In September 2009, the IRS issued guidelines for loan modifications effected on or after January 1, 2008. These guidelines provide servicers with greater flexibility to modify loans without the concern that modifications may incur significant tax penalties. The goal of the new guidelines is to ensure the continued performance of loans and maximize the probability that troubled loans will perform. However, it is important to note that the new guidelines only affect the REMIC structure. They do not change or adjust the loan modification restrictions that may be contained in the securitization documents, including the PSAs.

The IRS also issued proposed regulations that permitted certain types of modifications to be made to commercial mortgage loans held in a REMIC without causing a termination of its tax-exempt status. The regulations, which were also finalized in September 2009, provide that releases or substitutions of collateral, lien releases and changes in guaranties, credit enhancements, and changes to the recourse nature of obligations are permitted modifications and will not cause any such modified mortgages to fail to be qualified mortgages, as long as the loan obligations continue to be principally secured by real property. Under the regulations, the loan obligations will continue to be principally secured if the servicer “reasonably believes” that either the fair market value of the real property that secures the loan obligations is at least 80 percent of the adjusted issue price after giving effect to the modification, or, if the fair market value of the real property that secures the loan obligations is no longer valued at 80 percent of the adjusted issue price, the fair market value of the real property immediately after the modification equals or exceeds the fair market value of the real property immediately before the modification.

To arrive at a “reasonable belief,” the servicer is no longer required to obtain a new or updated appraisal, as was required under the servicer neither knows, nor has reason to know, are false, 2) how far into the future the possible default may be, though the revenue procedure does not provide a maximum period (i.e., there could be a significant risk of default even if the foreseen default is more than a year away), and 3) past performance of the loan, even if the loan is currently performing. Also, the servicer must “reasonably believe” that there is a “substantially reduced risk of default” for the loan following the modification. This may limit the modifications the servicer can make.

If a modification qualifies under the revenue procedure, the IRS will not 1) challenge the REMIC’s continued qualification as a REMIC on the grounds that the modification is not excepted from the definition of a “significant modification,” 2) contend that the REMIC has engaged in a “prohibited transaction” on grounds that a modification has resulted in one or more dispositions of qualified mortgages and that the dispositions are not otherwise excepted from the definition of “prohibited transaction,” 3) challenge the REMIC’s continued qualification as a REMIC on the grounds that the modification is a “power to vary the investment of the certificate holders” (which would otherwise make it ineligible for treatment as an investment trust), or 4) challenge the REMIC’s continued qualification as a REMIC on the grounds that the modification results in a deemed reissuance of the REMIC regular interests.

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Like any revenue procedure, 2009-45 is merely an interpretation of law issued by the IRS— in this case, what the “reasonably foreseeable default” rule means. While the effectiveness of this regulation is still unknown, the intent was to expand the types of loans in which default is reasonably foreseeable and to apply the expansion retroactively in order to avoid putting at risk many REMIC trusts that modified loans in 2008. Loan modifications that do not fit within the criteria of Revenue Procedure 2009-45 will not cause tax problems under the REMIC provisions if the modifications are occasioned by a borrower’s default or a reasonably foreseeable default.

**Limitations**

In addition to the limitations imposed by the REMIC rules, all servicers are required to service CMBS loans in accordance with the applicable PSA, the terms and provisions of the applicable loan documents, and a standard of conduct commonly referred to as the servicing standard.

The servicing standard, which is set forth in the PSA, involves several factors. First, a servicer must act in accordance with the higher of 1) the standard of care it extends to loans held for its own account and 2) the standard of care it applies to loans held for third parties. Second, the servicer must take into account the interests of the bondholders (and any other holders of participation interests in the loan) as a collective whole. Third, the servicer must service the loan with a view toward the timely collection of all principal and interest payments, or with respect to a loan that is in default, the maximization of recoveries on that loan on a “net present value” basis. Finally, the servicer must service the loan without regard to conflicts of interest, such as other business relationships it may have with the borrower, its ownership of a subordinated or pari passu piece of the loan, or obligations to make advances on the loan.

Moreover, the applicable pooling and servicing agreement must be taken into account in determining the authority to make any changes in the loan terms. Assuming that a loan is in default, what can the special servicer do? How much discretion does it have, particularly in light of the limitations imposed by the typical PSA?

As a general proposition, the REMIC rules and the standard PSA will allow the special servicer to modify a defaulting loan by 1) extending the maturity date, 2) modifying the interest rate, 3) reducing the principal amount of the loan, and 4) accepting a discounted payoff (consistent with the servicing standard)—in each case, provided that there is economic justification for doing so. The servicer is required to take action that results in the highest return to the REMIC trust.

The intended, albeit rather limited, flexibility granted servicers by the IRS in Revenue Procedure 2009-45 fails to address the fact that very few of the loan modifications that are permitted by the typical PSA and that the servicers would be willing to take (taking into account the servicing standard) would not be permitted under the prior reasonably foreseeable default standard. Moreover, it is difficult to imagine a scenario in which an agreement to modify a loan years in advance of a possible (and perhaps tenuous) default would be in the best interest of the bondholders, and it is difficult to accurately assess whether a modification would result in a better return to the REMIC trust. The revenue procedure is simply unable to do anything to address the limitations currently imposed by the PSAs governing the special servicer’s duties to the bondholders. Without a corresponding amendment to the PSAs, these limitations will continue whether or not the class of permissible default modifications under REMIC is expanded to include significant modifications regardless of imminent loan default status.

Finally, in addition to the limitations under the REMIC rules, the PSAs, and the servicing standards, if CMBS loan modifications are deemed “significant,” the special servicer may need to obtain the approval of a “control party.” For many recent vintage CMBS loans, there are multiple lenders with different levels of seniority and subordination. The control party is generally the holder of a majority (based on unpaid principal amount) of the most subordinate tranche, provided that it is still “in the money.” This means that the property (based upon an appraisal) has not suffered a loss in value that will result in more than 75 percent of the initial principal balance of that class of loans being no longer secured. In other words, if a particular tranche is underwater (debt exceeds equity) so that the remaining secured portion of that tranche is now less than 25 percent of the original balance, it is no longer in the money, and the next, more senior tranche, is in control.

For large CMBS loans with what are called B-Notes or other junior participations, the initial control party is typically the holder of the B-Note or junior participation. Most PSAs give the control party the right to consult with the special servicer and consent to any significant modifications affecting a defaulted CMBS loan. The control party will also typically have the right to replace the special servicer without cause. These rights provide the control party with some leverage to influence the direction of a CMBS workout. However, while a control party has the right to consult with and approve a special servicer’s proposed material action with respect to a defaulted CMBS loan, the approval cannot override the servicing standard.

So if there is a need to address modifications to a CMBS loan that is in distress, there must first be an event of default, or the servicer must “reasonably believe” that there is a significant risk of default of the premodification loan upon maturity, or some other reasonably foreseeable default, triggering a special servicing transfer event. The limitations imposed by the PSA must be considered, and the requested modifications must be measured against the obligations to the bondholders and the servicing standard. If the modification is significant, the control parties’ approval rights must be determined and, if necessary, approval must be obtained.

Thus, the timing required to effect a change in loan terms can be considerable in the case of a CMBS loan. While a defaulting portfolio loan can be restructured in a few days, a CMBS loan is likely to take several months, at best. Planning ahead is very important.

**Tips for Borrowers**

Given the unique challenges of CMBS workouts, there are a few practical pointers that borrowers should follow in attempting to work out a securitized commercial loan.

First, it is important to remember that these loans are often handled by an asset manager that is overwhelmed by borrower requests. Assuming that a borrower is able to gain the attention of the asset manager, the borrower may find that it only has one opportunity to obtain the asset manager’s focus and attention on the borrower’s particular problems and proposed resolution. Thus it is important to always be professional and cordial. Additionally, it is important to send all the relevant information that the servicer would need in a easily understood and coherent, well-laid-out package. If there are defects in the loan files, it is best to point them out early and offer a constructive solution.

Finally, a borrower should clearly demonstrate that it has done the necessary groundwork on market data, valuations, feasibility, and other appropriate items so that the proposed resolution makes sense. Anything that the borrower’s counsel can do to make the servicer’s job easier will go a long way toward a quick resolution.

A borrower’s ability to listen carefully is also important, since often a servicer will give practical advice on how to expedite the process. When the servicer sends the prenegotiation letter, borrower’s counsel should be careful not to “over-lawyer” the letter (though changes are sometimes nec-
essary). If things get bogged down early, urgency will be lost. Often, the borrower must be willing to pay down some portion of the loan, whatever it can, and clearly document its attempts at obtaining third-party refinancing proceeds. It is important for the borrower to know the goal it wants to reach and to have a plan to accomplish that goal. A borrower should not expect the servicer to put together a plan.

Second, a borrower should understand some of the negotiating tactics that will likely slow a workout down rather than productively moving the process forward. Lenders often react negatively to the intimation that the borrower and lender are partners or have any relationship other than one of borrower and lender. Borrowers that “go fishing” in an attempt to ascertain the amount of flexibility that is available are also likely to delay and hinder the process. In addition, lenders are also usually not receptive to a borrower’s request for a cash-flow note. Lenders generally require borrowers to put some additional cash into the property as part of a workout.

Absent real, hard evidence, borrowers also create obstacles when they suggest that the loan originator promised not to enforce any provisions of the loan documents or its remedies for a breach. Borrowers that are pleading poverty should not show up to a meeting in a private jet or mislead a lender about their financial condition; lenders do their due diligence. Finally, even though the process is arduous and long, a borrower should not let frustration derail it from effectuating its plan.

When dealing with a servicer, a borrower generally gets one chance to gain the attention of the people who can help. The borrower must have a sound solution to the asset’s problems. A borrower should assume that there will not be an opportunity to get the same level of attention a second time.

As the residential real estate market is finding a bottom, the problems with commercial loans have just begun. There are $714 billion dollars in outstanding commercial real estate loans that are securitized in CMBS bonds. The problem of dealing with those loans looms large. Unlike a portfolio loan, a CMBS loan in distress requires an understanding of the unique restrictions and limitations imposed by tax rules, the PSA, the loan agreement, and the servicing standard. While new guidelines offered in response to today’s economic landscape are not likely to significantly expand the ability of servicers to restructure commercial loans held by REMIC trusts, this is an area of law likely to evolve as the credit crunch continues. Making sure that the client understands its rights and has reasonable expectations...
on possible results is important, as is having the correct approach in dealing with a special servicer in seeking a modification of a CMBS loan.

1 Mortgage Bankers Association, http://www.mortgagebankers.org. The figure was reached in the second quarter of 2009. Of that amount, $378 billion was created in 2006 and 2007. Id.
3 Id.
4 Id.
5 The rate of defaults and late payments on property loans sold as commercial mortgage-backed securities jumped more than fivefold in the third quarter of 2009, to 4.52 percent from 0.8 percent a year earlier. This is according to Reis, Inc., which also reported that approximately $26.6 billion of CMBS loans were 60 days or more past due as of the third quarter of 2009. In calendar year 2007, $23.0 billion in CMBS bonds were issued. Commercial Mortgage Alert: Summary of CMBS Issuance, available at http://www.cmalert.com. The only new CMBS issued since June 2008 has been the recent $400 million single-borrower CMBS backed by 28 Developers Diversified Realty Corporation shopping centers, the first issue of commercial mortgage-backed securities under the Federal Reserve Bank of New York’s Term Asset-Backed Securities Loan Facility, or TALF, program. Id.
8 Once a loan is transferred to a CMBS pool in connection with a securitization, the master servicer under the PSA assumes the initial responsibility to service the loan (perhaps with the assistance of a subservicer). 10 I.R.C. §860A-G.
14 Id.
16 Prop. Treas. Reg. §1.860G-2(b). The regulations were finalized in September 2009.
18 Id.
19 Id.
20 Treas. Reg. §1.860G-2(b)(3).ii) 21 Id.
22 Id.
23 Id.
24 One problem with the calculation of who is “in the money” is that the death of deals during the past 12 months makes it difficult to ascertain market value, at least using the comparable sales appraisal method. While the consensus seems to be that the decline will be anywhere from 30 to 40 percent, from peak to trough, with the peak occurring sometime during the second quarter in 2007, the challenges of ascertaining when a tranche is in the money or not at any given time continue to exist.
Louis D. Brandeis

To combat Prohibition-era bootleggers who were using newfangled automobiles and telephones to service their thirsty customers, federal agents turned to a new technology of their own—wiretapping. In Seattle, they arrested and convicted Roy Olmstead, a local policeman, based on evidence obtained by tapping his phone. Olmstead appealed on the grounds that without a warrant the agents had violated his Fourth Amendment rights. The Supreme Court upheld the conviction because the government had never physically entered the premises. Justice Louis D. Brandeis dissented.

Brandeis, who 38 years earlier had cowritten one of the most famous law review articles in history, “The Right to Privacy,” used the Olmstead case to expound on the constitutional underpinnings of this fundamental right. Citing both the Fourth Amendment’s ban on unreasonable search and seizure and the Fifth Amendment’s protection against self-incrimination, Brandeis wrote that the Founders “sought to protect Americans in their beliefs, their thoughts, their emotions and their sensations. They conferred, as against the Government, the right to be let alone—the most comprehensive of rights and the right most valued by civilized men.”

Melvin I. Urofsky, author of the engaging and authoritative Louis D. Brandeis: A Life, calls this “one of the most eloquent—and most quoted—passages in American law” in “one of the landmark dissents in constitutional history.” These are perhaps the most effusive accolades Urofsky offers in this sober, sympathetic biography of an extra-ordinary man whose life as lawyer, reformer, or Supreme Court justice would have individually entitled him to be called a great and distinguished American.

The son of Jewish immigrants, Brandeis graduated from Harvard Law School in 1877 (with a grade point that would not be duplicated in his lifetime) and soon began practicing law in Boston. He rapidly established himself as a successful business and trial lawyer and became very wealthy, which afforded him the time to volunteer his pro bono services to a wide array of social justice causes, earning him the title “the People’s Advocate.”

In 1907, Brandeis successfully defended Oregon’s maximum hour law for women before the Supreme Court. He wrote an innovative brief that devoted less space to legal precedents and more to empirical data reflecting economic and social realities to show that the legislature acted “reasonably” in setting a limit on the number of hours a worker could be required to work. Known as a Brandeis Brief, it has influenced legal argumentation to this day.

In addition to his legal reform work, Brandeis, who was not a religiously observant Jew, became a committed Zionist dedicated to the creation of a Jewish state in Palestine. In 1916, Brandeis became the first Jew nominated to the high court. His nomination by President Woodrow Wilson drew vigorous opposition from pro-busines Senators and corporate leaders who feared that Brandeis would bring his progressive pro-labor views to the court. His confirmation battle was stained by anti-Semitism, shrouded as an inquiry into his “fitness” to serve. The New York Times and the Wall Street Journal opposed him, and former President William Howard Taft called his nomination “an evil and a disgrace.” Six former presidents of the American Bar Association and the president of Harvard University denounced his nomination, but in the end, Brandeis was confirmed by the Senate in a vote of 47 to 22.

Brandeis became a protege and then able ally of legendary Justice Oliver Wendell Holmes Jr. Together they dissented from efforts by the court’s majority to second-guess state legislatures on social and economic regulations and to repress individual constitutional rights. In the 1927 case of Whitney v. California, Brandeis opposed a California antisyndicalism law that suppressed free speech and gave eloquent voice to the underlying meaning and purpose of the First Amendment. He wrote: “Those who won our independence believed that the final end of the State was to make men free to develop their faculties…. They believed that freedom to think as you will and to speak as you think are means indispensable to the discovery and spread of political truth;… that fear breeds repression; that repression breeds hate; that hate menaces stable government; that the path of safety lies in the opportunity to discuss freely supposed grievances and proposed remedies; and that the fitting remedy for evil counsels is good ones…. Fear of serious injury cannot alone justify suppression of free speech and assembly. Men feared witches and burnt women. It is the function of speech to free men from the bondage of irrational fears…. To courageous, self-reliant men, with confidence in the power of free and fearless reasoning applied through the processes of popular government, no danger flowing from speech can be deemed clear and present, unless the incidence of the evil apprehended is so imminent that it may befall before there is opportunity for full discussion.

Brandeis remained on the Court for nearly 23 years, retiring in early 1939. According to Urofsky, Brandeis “brought to his battles not only the courage to fight powerful foes and to face the resulting social ostracism but also an unbounded energy, a determination never to lose a struggle because he tired of fighting it.”

In this skillfully told work, Urofsky has written the definitive biography of a monumental figure in American law whose rare blend of pragmatic idealism should serve as an inspiration today for lawyers and judges alike.

Stephen F. Rohde, a constitutional lawyer and chair of the ACLU Foundation of Southern California, is author of American Words of Freedom and Freedom of Assembly.
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Ethics 2010

ON SATURDAY, JANUARY 9, the Los Angeles County Bar Association and the Small and Solo Division will host a program on legal ethics. Speakers John W. Amberg, David L. Brandon, Evan A. Jenness, Diane L. Karpman, Joan Mack, Joel A. Osman, David B. Parker, and Jon L. Rewinski will review what to do when the attorney-client relationship ends, legal fees, and conflicts of interest. The program will take place at the Los Angeles County Bar Association, 1055 West 7th Street, 27th floor, Downtown. Parking is available at 1055 West 7th and nearby parking lots. On-site registration will begin at 8:30 A.M., with the program continuing from 9 A.M. to 1 P.M. The registration code number is 010611.

$90—CLE+Plus members
$100—Small and Solo Division members
$115—other LACBA members
$155—all others
$120—Webcast, LACBA members
$160—Webcast, all others
4 CLE hours with ethics credit

501(c)(3) Organizations

On Tuesday, January 26, the Taxation Section and its Exempt Organizations Subsection will host a seminar covering issues related to the formation and running of nonprofits. Speakers Christian G. Canas and Louis E. Michelson will discuss the definition of a nonprofit corporation, formation of a California nonprofit, applying for federal and state tax exemption, and compliance issues. The program will take place at the Los Angeles County Bar Association, 1055 West 7th Street, 27th floor, Downtown. Parking is available at 1055 West 7th and nearby parking lots. On-site registration and the meal will begin at 5:30 P.M., with the program continuing from 6 to 8. The prices below include the meal. The registration code number is 010525.

$35—CLE+Plus members
$65—Taxation Law Section members
$75—LACBA members
$90—all others
2 CLE hours

Persuasive Legal Writing

ON WEDNESDAY, JANUARY 20, the Los Angeles County Bar Association will host a program on persuasive legal writing led by noted appellate attorney Daniel U. Smith. The course shows how to persuade by creating headings, paragraphs, and sentences that embody brevity, simplicity, and clarity. Attorneys of all experience levels will benefit from this program, which provides 3.25 hours of specialization credit in appellate practice. The program will take place at the Los Angeles County Bar Association, 1055 West 7th Street, 27th floor, Downtown. Parking is available at 1055 West 7th and nearby parking lots. On-site registration and the meal will begin at 4 P.M., with the program continuing from 4:30 to 8:15. The prices below include the meal.

$115—CLE+Plus members
$135—Small and Solo Division members
$155—LACBA members
$190—all others
$160—Webcast, LACBA members
$195—Webcast, all others
3.25 CLE hours, with specialization credit in appellate law

The Los Angeles County Bar Association is a State Bar of California MCLE approved provider. To register for the programs listed on this page, please call the Member Service Department at (213) 896-6560 or visit the Association Web site at http://calendar.lacba.org/where you will find a full listing of this month’s Association programs.
It’s Time to Fix Arbitration Discovery

**ARBITRATION IS UNDER ATTACK TODAY** for being too cumbersome and too costly. Standard arbitration agreements and practices have taken on all the trappings of litigation—protracted discovery, extensive motion practice, and invocation of the rules of evidence. Litigators, accustomed to the rules and procedures of the courtroom, import those habits into arbitration, demanding broader discovery and motion practice. Some arbitrators respond by conducting arbitration hearings with the precision of a courtroom, feeling compelled to do so by the parties’ preferences. A recent survey indicated that corporate counsels are removing arbitration clauses from their contracts because they have concluded that arbitration is as cumbersome and costly as litigation. The latest edition of the American Institute of Architects construction forms, the nation’s most widely used template for building contracts, eliminates the default binding arbitration provision, long a sine qua non of construction contracts. Parties must henceforth affirmatively agree to arbitration by checking a box or, by default, go to court.

It is time to return arbitration to its fundamentals. Arbitration began as an efficient and economical binding dispute resolution procedure. It was designed to provide cost savings, shorter resolution times, a more satisfactory process, expert decision makers, privacy and confidentiality, and relative finality. Arbitration has had a long history in real estate and construction disputes, for which there is an acute need to close transactions, keep construction on schedule, and obtain financing without the fear of being tied up in court for years.

Why has arbitration become so expensive? A recent report by a committee of the New York State Bar Association\(^1\) attributed the cost explosion to the increasing use of wide-ranging discovery. Litigators have a tendency to try cases in arbitration with the same thoroughness and rigor as they would be tried in court. Arbitration, traditionally designed to operate with little or no discovery, gradually found itself burdened with extensive discovery and its commensurate costs. Even when the arbitration clause or rules limit discovery, it is not unusual for the lawyers to agree to expansive discovery.

If arbitration continues along this path, it is destined to collapse of its own weight. Recognizing this, a number of arbitration providers and the College of Commercial Arbitrators have developed arbitration protocols, rules, and recommendations about controlling discovery in arbitration.\(^2\) These efforts are good first steps, but implementing them will require businesses, in-house counsel, and outside counsel—the consumers of arbitration—to take a leap of faith and support the arbitrators and arbitration providers in their efforts to balance efficiency and fairness—and return arbitration to its fundamentals.

The first step is more effective and focused discovery. Based on the reports of the major arbitration providers, the following seven recommendations are a good place to start:

1) Draft or select arbitration clauses that limit discovery and that provide arbitrators with the ability to exercise their judgment to control the process. Do not incorporate the Code of Civil Procedure and broad discovery. An arbitrator can advise against invoking these rules but lacks the authority to control the process. The arbitration clause you draft will determine the arbitration you get.
2) Designate an arbitration provider that uses rules that are compatible with your goal of an efficient, cost-effective arbitration, and allow high-quality arbitrators to actively manage it from start to finish.
3) Focus document production requests narrowly with respect to relevant date ranges, number of custodians, and material evidence. Eliminate common boilerplate language such as wide-ranging demands for “all documents that refer to….”
4) The parties should cooperate in producing documents in a convenient and usable (i.e., searchable) format.
5) Agree upon search terms and use sampling to confirm the effectiveness of the terms. Cooperate in agreeing to the clawback of inadvertently produced privileged documents, eliminating the necessity for extensive and detailed review of all the electronic files being produced. Document review is incredibly expensive and often accomplishes little if the search terms have been properly defined.
6) Institute cost shifting if a requesting party demands broad and expensive production. Grant the arbitrator the authority to allocate costs after the usefulness of the production has been determined.
7) Balance need and burden, and give the arbitrator the ability to do so. Educate your client on the benefits of cost-effective arbitration and how it differs from litigation.

The beauty of arbitration and its fundamental advantage over litigation is the opportunity to choose the dispute resolution procedures and the decision maker (the arbitrator) that you want. Lawyers who are unhappy with the current state of arbitration should advise their clients on how they can structure the arbitration process to better serve their goals and priorities.

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\(^1\) **New York State Bar Association, Arbitration Discovery in Domestic Commercial Cases: Guidance for Arbitrators in Finding the Balance Between Fairness and Efficiency (2009).**


Kenneth C. Gibbs and Barbara Reeves Neal are arbitrators and mediators with JAMS.
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