Los Angeles attorney Lindsay McMenamin analyzes the defenses for third-party claims brought against mortgage appraisers.

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Appraising Defenses

Appraising Defenses

Los Angeles attorney Lindsay McMenamin analyzes the defenses for third-party claims brought against mortgage appraisers.

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The 24-hour news cycle reminds us relentlessly that there are real reasons to see doom and gloom in the economy at large and the real estate sector. Residential foreclosures continue, with the Mortgage Bankers Association recently predicting it will take another three to four years before the typical pattern of delinquencies and foreclosures returns. The commercial real estate market remains sluggish at best. While bank closures in 2011 are down compared to 2010, the nation’s largest lenders continue to face harsh stress tests. Unemployment remains high. Abroad, the European debt crisis casts a pall of uncertainty over the stock market. The negative headlines are hard to digest. We are not so far gone from the days of irrational exuberance in the real estate market and economy at large that we have forgotten the contrast. Nevertheless, the failure of Kardashian’s fairy tale marriage shows how important it is to look beyond the headlines. Since the popping of our large real estate and credit bubble, some good news has emerged. We can now look behind us at several years of working through the inevitable consequences. For those who can refinance, interest rates are at historic lows. Commercial real estate values in Southern California have declined but not plummeted, and deals are being done (even if at a much slower pace) despite the tightened credit market and unimproved vacancy rates. While the UCLA Anderson Forecast’s outlook for the nation in third quarter 2011 was “far worse” than it had been three months earlier, the report concluded that California would experience growth—albeit slow growth—through the end of 2012.

It is true that macroeconomic factors remain uncertain, but 2012 is an election year, and our future is not written in stone. Kardashian will probably never reconcile with Kris Humphries. But for those who have moved from irrational exuberance to irrational disillusionment, we can repeat the mantra of the real estate lawyer: Real estate has always been cyclical, no matter what else is going on in the world.

Meanwhile, while we await the next up-cycle, there is still opportunity in this downturn—if only to shed excesses, reposition, and avoid liability. This month, Los Angeles Lawyer shares insights on how single asset real estate debtors can use bankruptcy to reorganize and also offers tips for creditors. We analyze a landlord’s claim for damages for breach of a lease when a tenant files for bankruptcy. Lenders and borrowers as well as note purchasers and other investors may find fresh strategies by reviewing the procedures for foreclosure in California. Contractors and appraisers—two market participants hit hard by increased claims from pre-meltdown activities and decreased demand post-meltdown—will learn, respectively, how to recover attorney’s fees in mechanic’s lien litigation and the best defenses to liability.

Whether or not you are optimistic about 2012, we hope that you can take advantage of the opportunities that do exist, or at least not mourn the shattered fairy tale for too long. We hope you find this Real Estate Law special issue to be helpful in your practice. We express our heartfelt appreciation to our authors for their exemplary contributions to the issue.

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HAPPY NEW YEAR! As 2012 begins, there is reason to hope it will bring some happiness. Business seems to be picking up, fitfully. Unemployment is starting to edge down, unevenly. And we have suffered no new catastrophes, at least as I write this. That’s all welcome news after four years of a “great” recession punctuated by financial market swoons, private and public sector layoffs, business closings, and court shutdowns—not to mention occasional wildfires, floods, and hurricane-force winds. It’s been quite a ride since 2008. If 2011 had any defining themes, most lawyers might label them “hard times,” “tough challenges,” or “getting by with less”—in each case, preceded by “more.” But today, both for the broader economy and for the legal profession, things may be turning a corner. Personally, I’m closing the door on 2008-11 by remembering things I still feel grateful for. Among them:
• It’s still great to be an Angeleno.
• It’s still a great privilege to be a lawyer.
• As a Los Angeles lawyer, it’s still great to be part of LACBA.

For me, all three are still true, even after four relatively rough years. I hope each of you can say much the same for yourself and that 2012 will bring you even more to be grateful for.

Challenges Remain, and More Will Be Coming

We still face major challenges, of course. Uncertainty and change continue to rock private practice. After years of law firm downsizing and closures (including some major firms), there is welcome growth in some practice areas. But it is coupled with directionless ups and downs in many others, and continued decline in some. Tight client budgets and increasing general competition for legal work still pressure most private practice lawyers. Growth in ready-made legal research and form documents, overseas outsourcing, and other alternatives to the traditional packaging and delivery of legal services drives the law business to keep adapting the services it provides, how they are provided, and how they are priced.

In the world of nonprofit legal services, a still-tepid economy means charitable giving as well as government and foundation support has not yet recovered with the vigor necessary to meet needs still increasing as a result of the recession. The “justice gap” in legal services for those of limited or modest means is real, sizable, and still growing. In less well-to-do communities already hard-hit by the economic downturn, the consequences are dire. Laws unenforced, rights not vindicated, and justice forgone mean more suffering.

In the public sector, government is shrinking on all levels—federal, state, and local—and in all parts of the justice system—prosecutors, public defenders, regulators, and the courts themselves. Although much can be said for the benefits of leaner, more efficient government, many consequences of the current government downsizing are having significant, and often profoundly damaging, impact on lawyers, our clients, and the larger communities in which we live and work.

In addition, the legal profession faces regulatory uncertainty as our State Bar’s governance and approach to public protection changes. The future of the State Bar as a “unitary” bar that both supports lawyers and regulates them may be in doubt. And regulation of lawyers is increasingly complicated by the blurring of boundaries on many fronts: more and more lawyers in different jurisdictions and both lawyers and nonlawyers compete for the same business opportunities and even work together for the same firms. The regulation of law practice has not caught up to that reality.

The days of law as a comfortable professional island are long gone. We’re in a business now. All lawyers today—including those in the nonprofit and government sectors—feel the pressures of budgets and performance metrics, and know the sting of adverse consequences when budgets are tight or performance does not measure up. For private practice lawyers, it’s all that, plus the external pressures of an open and dynamic competitive market for our services. For lawyers in smaller or solo practice—who make up the preponderance of the Los Angeles legal community and LACBA’s membership—getting the needed help to deal with more change and challenges in that already pressure-filled environment is especially tough.

The continuing advance of technology does more than quicken the pace of all these changes in the legal profession. Technology also creates its own unique changes and presents its own challenges. In the age of instant publication via social media and other Internet-based outlets, the adage that every communication should be composed as if it will appear in the mass media is even more true. Moreover, when every communication, document, and image can be—and likely is—put into electronic form and transmitted or stored, usually with multiple copies in different locations, can anything ever be truly private? Will anything ever again be lost or forgotten? But how to keep track of it all, to locate if and when needed? There is good reason that e-discovery, data management, and electronic sleuthing are among the fastest-growing areas of law-related expertise.

At the same time that all these changes push us into new territories, we lawyers still carry with us the burden of our special professional responsibilities—our ethical and legal duties to protect confi-
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dences, to serve our clients’ interests zealously, and to honor our role as officers of the courts.

The day-to-day juggling act required to balance law-as-business and law-as-profession in the Internet age might be called a challenge too. It’s quite a feat, to be sure. But it is also now the routine performance we all have to deliver, in the manner of a well-trained athlete, in the ordinary course of every day we practice law. The larger challenges that continue to shake and reshape our playing field are something else again.

**Rising to Meet Challenges**

Change and challenge can, of course, be the source of opportunity and growth—especially for those who take action. To consider how we might navigate into a better future, it is helpful to think briefly about our past as Los Angeles lawyers. For nearly 140 years now, LACBA has built a proud history of leadership, both within the legal profession and in the broader community in Southern California.

Throughout those 14 decades, Southern California has been, as it certainly remains today, one of the most dynamic and diverse economic and social environments on earth. Here in Los Angeles, change and the challenges it brings have always been a constant. Economic booms and busts come and go, sometimes with shudders as terrifying as the tectonic shifts that physically shake our homes. New ideas, new businesses, and new populations arrive like regular waves on the Pacific shore.

But we Angelenos usually manage to hang on, adapt, and prosper with change. I think we even enjoy it—and prosper because of it. Many surfers—those quintessential Southern Californians—will tell you not to try to fight a big wave. The key to a good ride is to catch the right wave, at the right time, and let it take you where you want to go.

Because LACBA makes its home in Los Angeles, it is unsurprising that many of the most important parts of LACBA’s proud history involve LACBA changing itself and leading change in the legal profession, when changes are needed. We are at our best when we rise to meet those challenges.

Two examples come to mind. First, LACBA’s commitment to access to justice—a term not even part of its regular vocabulary 50 years ago—grew piece-by-piece out of changes and crises in the profession and in our communities over the past four decades. Today, providing necessary legal services to people of limited or modest means is an important part of LACBA’s identity, mission, and programs. Through LACBA’s own programs and pro bono projects, we directly serve the needs of more than 50,000 such clients each year. In addition, through our partnerships with Public Counsel, LAFLA, and other local legal aid providers, we stream thousands of pro bono attorney volunteers into those organizations each year to help their clients.

Second, like our commitment to access to justice, LACBA’s commitment to diversity grew out of significant changes in our community and society. Fifty years ago, LACBA was—as was the Los Angeles legal profession generally—overwhelmingly male, white, Anglo, and Protestant. Over the past four decades, however, barriers within LACBA have fallen. Today, like our membership as a whole, LACBA’s board of trustees, sections, committees, and volunteers are as diverse as they have ever been: more women lawyers, lawyers of color, non-Christian lawyers, and LGBT lawyers. Today, lawyers reflecting almost every part of the human mosaic that is the Southern California population join LACBA to work together, side by side, for the betterment of our profession and our communities.

**Meeting Our Challenges and Helping You Meet Yours**

Even if our history shows that we can rise to challenges and adapt successfully, what do we do now? How do we rise to respond to the multiple forces—economic, regulatory, and technological—reshaping the legal profession in Los Angeles today? There is probably no single correct response, and the array of best responses may differ depending on our individual situations.

Because LACBA is, first and foremost, a membership organization, helping you find your personal best answer to that question is part of our mission. Because knowledge and connections are keys to success in the dynamic and fast-changing legal profession, LACBA offers the widest array of top-notch live legal educational and networking programs in Southern California. If you want to keep up with changes, look to those LACBA events and the other tools and opportunities that LACBA offers our members. Today, we host more than 1,000 meetings and events each year—including substantive section and committee meetings, bench-bar and legal-business networking events, and CLE programs. LACBA’s live CLE programs number more than 250 each year, and we also offer a current library of online programs and our unique CLE-in-a-Box, representing tens of thousands of quality CLE hours. We feature the prominent players, the top experts, and the current hot topics, all at prices for LACBA members that cannot be beat.

In short, if you are a LACBA member, you probably won’t need to look elsewhere for a good way to keep current in your prac-
The ABCs of California Foreclosure Law

THE REAL ESTATE MELTDOWN that began in late 2007 has resulted in an unprecedented number of loans in default and a substantial upsurge in foreclosures across the country. California continues to be one of the states hardest hit by the foreclosure crisis. Whether representing a borrower struggling to make its mortgage payments or a lender faced with a defaulted loan, it is essential for lawyers to have an understanding of the intricacies of California foreclosure law.

The starting point for this understanding is the statutory framework for nonjudicial foreclosure as well as California’s famous (or perhaps infamous) “one-action rule.”

In California, a lender considering foreclosure may choose one of two avenues—judicial or nonjudicial foreclosure—although sometimes a lender elects to commence a judicial foreclosure and a nonjudicial foreclosure to preserve (for a time) both options. Judicial foreclosure, as the term suggests, begins with the lender filing a complaint against the borrower. As with most litigation, this process can be drawn out and expensive. Nonjudicial foreclosure, on the other hand, is relatively inexpensive and less time-consuming.

A critical distinction between judicial and nonjudicial foreclosure is the lender’s ability to pursue the borrower for a deficiency judgment if the sale price is less than the full amount of the borrower’s obligation. A deficiency judgment is an option only for lenders who choose judicial foreclosure. For loans that are nonrecourse by statute or that contain contractual nonrecourse clauses, it generally does not make sense for the lender to foreclose judicially, because the principal benefit of judicial foreclosure—the possibility of a deficiency judgment—is not available.

Nonjudicial Foreclosure

The remedy of nonjudicial foreclosure is found in a deed of trust. A deed of trust—the preferred instrument in California for securing a borrower’s loan obligations with real property—almost always contains a “power of sale” clause that enables the trustee (typically a title insurance company) to sell the property to satisfy the borrower’s obligations if a default occurs.

The nonjudicial foreclosure rules are statutorily prescribed and require strict compliance. The rules endeavor to strike a balance among the varying interests of lenders, borrowers, other lien claimants, and trustees.

The nonjudicial foreclosure rules are statutorily prescribed and require strict compliance. The rules endeavor to strike a balance among the varying interests of lenders, borrowers, other lien claimants, and trustees.

If any step in the foreclosure process violates the nonjudicial foreclosure statute, the validity of the foreclosure sale may be challenged. The borrower may be able to enjoin the sale and recover damages from the lender.

When a borrower defaults on an obligation secured by a deed of trust, the lender sometimes may prefer to restructure or “work out” a loan—for example, by reducing the interest rate and/or required periodic payments, or extending the maturity date. In other cases, the lender may decide that a workout is not realistic or in the lender’s best interest. In such a case, the lender will elect to declare a default, which starts in motion the process for selling the property pursuant to the power-of-sale provision. The first step is for the lender to make a demand on the trustee to commence the foreclosure process.

Notice of Default

One of the main components of the statutory scheme is the stringent notice requirements. Upon receipt of the lender’s demand, the trustee initiates a nonjudicial foreclosure by recording a notice of default (NOD) in the county in which the property is located. The purpose of the NOD is to provide notice to the borrower, its successors, junior lienholders, and other interested persons—and notice to the world—that there has been a default. The NOD must identify the name of the borrower, include recording information for the deed of trust or the legal description of the property, specify the type of breach that has occurred and the specific dollar amount due, declare the lender’s election to sell the property, and include the lender’s contact information.

The NOD must also contain a statement notifying the borrower that the default can be cured by payment of the delinquencies within the prescribed reinstatement period. However, if the note grants the lender the right to accelerate payment of the entire debt upon the borrower’s default, the NOD does not need to articulate the lender’s election to accelerate.

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The trustee is required to mail a copy of the NOD to the borrower within 10 days of the recordation date and to all persons who have previously recorded a “request for special notice” of any default under the deed of trust. Within one month after recording the NOD, the trustee also must send a copy of the NOD to any successor of the borrower and any junior lienholders.14

Once the NOD is recorded, the foreclosure clock starts ticking. For the three months following recordation of the NOD, the borrower (and any successor), as well as any junior lienholder with a recorded lien, each has the opportunity to cure the default and “reinstate” the loan by paying all amounts in default and all reasonable costs and expenses incurred by the lender, including trustee’s and attorney’s fees, but excluding any portion of the principal that would not otherwise be due had the default not occurred. This exclusion allows the borrower to reinstate the loan without paying the entire debt. However, if the default resulted from the borrower’s failure to pay the entire principal balance at the maturity date, reinstatement is not possible.

The borrower, its successor, and any junior lienholder may exercise this reinstatement right beginning on the date of recordation of the NOD until five business days prior to the sale. If the default is cured, the borrower’s obligation is reinstated according to its original terms as if no default had occurred. Within 21 days following reinstatement, the lender must deliver to the trustee a notice of rescission of the NOD, which withdraws the declaration of default and demand for sale and advises the trustee of the reinstatement. The trustee must record the notice of rescission within 30 days after the trustee receives the notice and all fees and costs owing to the trustee.15

A minimum of three months must transpire after the NOD is recorded before the trustee may record a notice of sale (NOS).16 The NOS must specify the date, time, and location of the sale and include a description of the property and the deed of trust, the terms of the sale, the trustee’s contact information, the total amount of the unpaid balance of the obligation, and a reasonable estimate of costs incurred by the lender at the time of the initial publication of the NOS.17

At least 20 days prior to the sale, the trustee is required to record the NOS, mail the NOS to the borrower and all persons who requested special notice, post the NOS at the property itself and in one public place in the county in which the property is located—standard practice is to post the NOS at a courthouse—and publish the NOS in a newspaper of general circulation in the city in which the property is located. The NOS must be republished once a week for three consecutive weeks.18

The sale can be postponed for a number of reasons at any point before a bid has been accepted on the day of the sale. The postponement period can last for up to one year from the date of the original sale, after which time a new NOS must be published, posted, mailed, and recorded. Reasons for postponement include 1) the borrower and lender mutually agree to postpone the sale, 2) the borrower files for bankruptcy protection, 3) a court enjoins the sale, 4) the lender decides unilaterally to postpone the sale, and 5) the trustee postpones the sale to protect the interests of either the borrower or lender.

If the sale is not postponed, it must take place at the location and time specified in the NOS and be open to the public.19 Any person, including the borrower and lender, may bid at the sale. The trustee will sell the property by auction to the highest bidder for cash, although the lender is entitled to “credit bid” up to the full amount of the indebtedness. The trustee has the right to require all prospective bidders to show evidence of funds prior to commencing the bidding (usually a cashier’s check in hand).20 Upon completion of the sale, a trustee’s deed upon sale is recorded, transferring title to the successful bidder.

One-Action Rule

California’s one-action rule provides that there can be but one form of action for the recovery of any debt, or the enforcement of any right, secured by a mortgage upon real property.21 The word “one” in one-action rule is used qualitatively and not quantitatively and refers to the rule that the lender’s only option to recover a debt secured by a mortgage or deed of trust upon real property is to foreclose on the collateral securing the debt. It is crucial that a lender be advised of the requirements of the one-action rule, as certain conduct that does not on its face appear to constitute an “action,” such as a bank lender exercising a statutory right of offset against an account held by its borrower, may violate the rule.22

The one-action rule has two elements. First, the lender must pursue foreclosure before taking any other action against the borrower for recovery of the debt.23 Second, all the security must be exhausted before the lender sues the borrower directly on the debt.24 However, since a deficiency judgment is unavailable in a nonjudicial foreclosure sale, the lender cannot pursue the borrower for a personal judgment if the sale proceeds from a trustee’s sale are not enough to satisfy the debt. In jurisdictions without such a rule, the borrower can be forced into the untenable position of simultaneously having to defend a personal action on the debt and a foreclosure.
sure action on the real property.

The invocation of the one-action rule is at the borrower’s option. When a lender initiates proceedings to collect a personal judgment against the borrower, the borrower can raise the one-action rule as a defense and compel the lender to foreclose and apply the sale proceeds to satisfy the debt. In the alternative, the borrower can elect not to assert the defense, in which case the lender that has not foreclosed is deemed to have made an election of remedies. The lender can recover a personal judgment against the borrower—but at the price of losing its lien and therefore its right to foreclose on the real property.

The one-action rule is widely misunderstood. Moreover, a violation of the rule can result in devastating consequences for the lender. Before commencing a foreclosure—whether judicially or nonjudicially—a number of strategic considerations must be evaluated. Foreclosure can be a byzantine process for lenders and borrowers. It is the role of real estate counsel to provide guidance and demystify the complexities of California foreclosure law.

1. CODE CIV. PROC. §580d. Note that §580d would not necessarily preclude an action against a guarantor of the loan for any deficiency if the guaranty contained properly drafted waivers.
2. See id.
3. CIV. CODE §§2932-2933.
6. Prior to declaring a default, a lender should review the loan documents to confirm that all required notices have been properly given and that any cure periods have expired.
7. Note, however, that if the default is nonmonetary, foreclosure may not be an option unless the default consists of a material breach of a material covenant.
9. CIV. CODE §2924(a)(1).
11. CIV. CODE §§2924(a)(1), 2924(c)(1).
12. CIV. CODE §2924(c)(1).
14. CIV. CODE §2924b.
15. CIV. CODE §2924c.
16. CIV. CODE §2924(a)(2)-(3).
17. CIV. CODE §2924(b)(1).
18. CIV. CODE §§2924b(b)(2)-(3), 2924(b)(1).
19. CIV. CODE §2924g.
20. CIV. CODE §2924(h).
21. CIV. CODE §2924(a).
24. CODE CIV. PROC. §726.
26. See, e.g., Wozab, 51 Cal. 3d at 1004-05.
LITIGATION IS A COSTLY UNDERTAKING, often making the ability to recover attorney’s fees a key consideration for clients deciding whether to pursue a claim. The mechanic’s lien laws of California provide contractors, subcontractors, and material and equipment providers with statutory authorization to obtain attorney’s fees even without a contractual basis for recovery. A mechanic’s lien allows a contractor to lien, and ultimately foreclose upon, the real property the contractor caused to improve if the entity it contracted with does not pay, provided the contractor has satisfied certain statutory prerequisites. The special rights afforded contractors can be traced to the adoption of the California Constitution:

Holders of mechanics’ liens are protected by constitutional mandate. “The mechanics” lien derives from the California Constitution itself; the Constitution of 1879 mandated the Legislature to grant laborers and materialmen a lien upon the property which they have improved; no other creditors’ remedy stems from constitutional command….Moreover, the courts have uniformly classified the mechanics’ lien laws as remedial legislation, to be liberally construed for the protection of laborers and materialmen…. The special creditor rights bestowed on contractors to lien real property has been justified by the notion “that the recordation of a mechanics’ lien, or filing of a stop notice, inflicts upon the owner only a minimal deprivation of property; that the laborer and materialman…have enhanced the value of that property; and that state policy strongly supports the preservation of laws which give the laborer and materialman security for their claims.”

Given the superior rights afforded contractors by the California Constitution to enforce fee collection, it is not surprising that they have also been given a statutory right to recover attorney’s fees, costs, interest, and even penalties. The exercise of this right frequently occurs in disputes over release of what is known as retention. Specifically, construction contracts usually grant owners the right to retain 10 percent from a contractor’s payments until a project is completed. Under the Civil Code, for a private work of improvement, a project owner must pay this retention to the prime contractor within 45 days of project completion. Within 10 days of the prime contractor’s receipt of the retention proceeds from the owner, the prime contractor is obligated to pay that portion of retention owed to each subcontractor. Disputes often focus on whether a project has actually been completed and, therefore, if the obligation to pay retention has matured. When this happens, an owner can withhold from the prime contractor, or the prime contractor can withhold from a subcontractor, 150 percent of the disputed amount until the dispute is resolved. If retention proceeds are not paid timely and a prime contractor (or subcontractor) prevails in suit against an owner (or contractor), the prime contractor (or subcontractor) is entitled to recover 2 percent per month on the wrongfully withheld monies. Further, the prevailing party (the prime contractor, subcontractor, or owner) is entitled to recover attorney’s fees and costs. Thus, in order to preserve a claim for fees, costs, and interest under the Civil Code a key issue at trial is substantiating that the disputed funds actually constitute retention.

The Civil Code provides prime contractors on private works of improvement with the same rights on progress payments. A project owner has 30 days after a contractual demand for payment (typically, an invoice) to make a progress payment. If the owner fails to pay one or more progress payments and the prime contractor sues the owner to recover those amounts, the contractor is entitled to receive 2 percent per month on the wrongfully withheld progress payments and may recover its attorney’s fees and costs.

Public Works

For public works projects, a public entity is required under the Public Contract Code to release retention to a prime contractor within 60 days of a project’s completion. Like private works projects, if a dispute occurs and monies are actually due and owing, a public entity

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can withhold from the prime contractor (or the prime contractor from a subcontractor) 150 percent of the contested amount until the dispute is resolved.14 In contrast to private works of improvement, however, a prime contractor for a public works project must pay retention to each subcontractor within 7 days15 rather than 10. On the other hand, with public works projects (as with private ones), a prevailing prime contractor or subcontractor may collect 2 percent on amounts wrongly withheld and recover attorney’s fees and costs.16

Similarly, the Business and Professions Code protects the right of subcontractors to recover progress payments that a prime contractor fails to make. Regardless of whether a project is a private or a public work of improvement, a prime contractor must pay a subcontractor within 10 days of receipt of payment.17 If the contractor does not make payment by that deadline and the subcontractor brings suit and prevails in its action, the subcontractor may not only recover its attorney’s fees and costs but is also entitled to collect 2 percent per month on the wrongfully withheld monies as a penalty.18 When this penalty is added to the legal rate of interest of 10 percent that can be collected on a judgment for breach of contract, a subcontractor could potentially recover at least 34 percent per annum on the sums owed to it.19

Certain California statutes refer to the 2 percent per month penalty as a “charge” that is “in lieu of any interest otherwise due.”20 Other statutes characterize it as a “penalty” but do not contain a corresponding provision that this penalty is in lieu of interest otherwise due.21 Thus, it is critical to know which of these two different statutory references applies in a given situation, because it is entirely conceivable that a party could effectively recover interest on top of interest. Stated differently, if the applicable code section specifies the imposition of a “penalty,” a party would not be precluded from recovering interest at 2 percent per month in addition to the interest allowed at the legal rate or the contract. On the other hand, if the relevant statute mandates that the 2 percent be treated as a “charge,” a party should be barred from recovering an additional interest payment.

Stop Notices and Payment Bonds
In addition to the rights afforded by a mechanic’s lien, contractors have another powerful tool to recover fees. A “stop notice” or “notice to withhold” allows a contractor to assert a claim directly against a construction loan proceeds. A stop notice is available on private and public works projects.22 Under Civil Code Section 3158, a prime contractor can serve a stop notice on a lender but not on the owner. When an owner is served with a stop notice by a subcontractor, the owner is generally required to withhold from the prime contractor sufficient money to answer the claim. In private works projects, contractors can take the additional step of obtaining a bonded stop notice, which provides contractors with another potential means of recovering attorney’s fees and costs.23 If a contractor decides to purchase a stop notice bond in order to pursue a claim against a construction lender, the lender must withhold funds24 upon receipt of the bond as long as the contractor has met certain statutory prerequisites.25 Therefore, if the contractor decides to file a bonded stop notice claim and names the lender as a party in the action, the prevailing party in that action is entitled to recover “reasonable attorneys’ fees in addition to other costs and in addition to any liability for damages”26 from the entity found liable by the court.

In contrast to the practice for private works of improvement, public entities typically require a prime contractor to obtain a payment bond on public works projects. On a public works project a contractor generally has a payment bond under which to make a claim, because under Civil Code Section 3247(a), “Every original contractor to whom is awarded a contract by a public entity, except as provided in...the Public Contract Code, involving an expenditure in excess of twenty-five thousand dollars...for any public work shall...file a payment bond...” Additionally, under Public Contract Code Section 7103(a), “Every original contractor...awarded a contract by a state entity...involving an expenditure in excess of five thousand dollars for any public work shall...file a payment bond...”

Because of these payment bond requirements, subcontractors have another mechanism by which to recover their attorney’s fees. Specifically, the surety issuing the payment bond must pay any subcontractor among others, who is not paid for its work on the project.27 In fact, the same Civil Code section mandating that payment bonds be issued for the benefit of subcontractors also requires that the language of bonds themselves provide that the sureties will pay reasonable attorney’s fees if a lawsuit is brought to recover on a payment bond.28

Mepco and Performance Bond Claims
In 2007, a prime contractor, Mepco Services, Inc., sued an Orange County school district for breach of contract and other causes of action.29 The contract between Mepco and the school district did not have an attorney’s fees provision but did require the contractor to obtain a performance bond.30 The school district responded by filing a cross-complaint against Mepco and the surety that issued the performance bond. A performance bond, unlike a payment bond, is a bond that the public entity can look to when the contractor fails to perform under the contract. Under the performance bond, the surety is required to satisfy the prime contractor’s obligations under the prime contractor-public agency contract. The public agency claimed that the contractor was at fault for the project delays, with the result that the agency was entitled to liquidated damages.31 The performance bond provided for recovery of attorney’s fees solely by the school district.32

After Mepco received a jury verdict in its favor, the contractor sought to recover its attorney’s fees based on the terms of the performance bond, notwithstanding the fact that the terms of the bond limited the award of these fees to the school district.33 Mepco argued that the terms and conditions of the performance bond were an integral part of the agreement between it and the school district, even though the bond was a document separate from the contract. The trial court agreed with Mepco and awarded attorney’s fees to the contractor.

In affirming the lower court ruling, the appellate court concluded that "the trial court properly determined that it could award Mepco attorney fees pursuant to the terms of the performance bond."34 The basis for the appellate court decision rested first on the school district’s decision to include a claim in its cross-complaint for enforcement of the bond against Mepco and its surety and to seek recovery of its attorney’s fees. If the school district had prevailed in its enforcement action, the district would have been allowed its attorney’s fees. Accordingly, based on the reciprocity principles set forth in Civil Code Section 1717(a), Mepco was entitled to a similar recovery in defending against the performance bond claim.

The appellate court also stressed that Mepco was entitled to attorney’s fees because a common issue existed between the school district’s affirmative claim that Mepco had breached its contract with the district and Mepco’s defense against that claim. Before the school district could recover against the bond, it first had to establish that Mepco had defaulted. Since Mepco was successful in defending against that accusation, the contractor not only defeated the district’s breach of contract claim but also succeeded on its own breach of contract claim. Since the school district would have been entitled to attorney’s fees and costs if the verdict had been in its favor, reciprocity compelled the same result for Mepco when it prevailed.

Since public works contracts rarely contain an attorney’s fees provision, the ruling in Mepco is significant because it provides contractors with the ability to recover attorney’s fees whenever a public entity seeks to recover attorney’s fees. A prime contractor would be well advised to ensure that the performance bond contains a provision for attorney’s fees. Mepco’s decision to pursue recovery of attorney’s fees resulted in a significant cost savings to the school district.35

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fees through the provisions in a performance bond authorizing recovery. Mepco effectively purchased the right to recover its attorney’s fees when it obtained the bond that it was statutorily required to provide for the project. Under Mepco, when there is a performance bond, contractors have an alternative means of collecting attorney’s fees, because these bonds ordinarily contain such a provision.

One issue that remains is whether a public entity must pursue a claim under a performance bond in order to trigger the attorney’s fees clause in that bond. Given the court’s ruling in Mepco, lawyers for public agencies will argue that their client must make a claim under the bond before a contractor can invoke the attorney’s fees provision in that bond. On the other hand, lawyers for contractors may argue that the bond is an integral component of the overall contract documents and, therefore, it is unnecessary for the public entity to pursue a claim on that bond as a prerequisite to a contractor having recourse under the attorney’s fees provision of the bond. Contractors may also benefit from the court’s ruling in Mepco because public agencies may reconsider making a claim against a contractor’s performance bond if it means that they may be subject to the attorney’s fees provision of the bond if they are not the prevailing party.

Contractors in California are afforded a host of recovery rights afforded to no other creditors. Contractors must not only be completely familiar with these rights in order to protect their interests and maximize the potential recovery that can be obtained in any litigation, they must also know the applicable statutory prerequisites required to invoke those rights and ensure they are in compliance.

1 See Civ. Code §3260 et seq.
3 Connolly Dev., Inc. v. Superior Court, 17 Cal. 3d 803, 828 (1976).
4 Civ. Code §3260(c).
5 Civ. Code §3260(d).
7 Civ. Code §3260(e).
8 Civ. Code §3260(g).
9 Id.
10 Civ. Code §3260(h).
11 Id., Civ. Code §3260(g).
13 Id.
16 Bus. & Prof. Code §7108.5(a), (b).
17 Bus. & Prof. Code §7108.5(b).
18 See Civ. Code §3289. “If a contract...does not stipulate a legal rate of interest, the obligation shall bear interest at a rate of 10 percent per annum after a breach.”
19 See, e.g., Civ. Code §3260(g); Pub. Cont. Code 7107(f).
20 Id. at 1045.
21 Id. at 1030.
22 Id. at 1045.
23 Civ. Code §§3159(a). The attorney’s fees provision in the performance bond reads: “Contractor/Principal and Surety agree that if the DISTRICT is required to engage the services of an attorney in connection with the enforcement of this bond, each shall pay DISTRICT’s reasonable attorneys’ fees and costs incurred, with or without suit, in addition to the above amount.”
Formal Opinion No. 524: What Are the Ethical Responsibilities of an Attorney with Regard to the Hiring of Nonlawyer Employees Who May Be in Possession of Confidential Information?

SUMMARY

This opinion addresses the duties of an attorney who hires a nonlawyer (such as a law clerk, secretary, researcher, investigator, etc.) who has previously worked in a capacity in which the nonlawyer may have been exposed to or acquired confidential information, pertaining to an adverse party, that may be material to matters on which the hiring firm is engaged. The committee believes that it is the obligation of the hiring firm, before hiring a nonlawyer employee who has worked on matters at another firm, to conduct a reasonable investigation into whether the proposed employee has been exposed to or acquired confidential information during prior employment relevant to legal matters that may arise in the course of the new employment. The hiring firm should in particular ascertain whether the proposed employee’s former firm is or has been opposing counsel to the hiring firm on any current cases, to determine whether the proposed employee has been exposed to confidential information of an adverse party or witness regarding those cases. However, the hiring firm must not attempt to delve into the substance of any information the nonlawyer may have acquired. It is the obligation of the hiring firm to instruct the nonlawyer employee, once hired, as to his or her confidentiality obligations, and, absent first obtaining the consent of the former employer or the affected client of the former employer, to promptly screen the nonlawyer employee from involvement in particular matters if the nonlawyer is in possession of confidential information that is materially related to matters in which the hiring firm represents an adverse party. The opinion also addresses the elements of an adequate screen.

TABLE OF AUTHORITIES


STATEMENT OF FACTS

An attorney at Second Firm hires two law clerks for the summer to work on intellectual property cases, including a case by Second Firm’s client Writer against Studio over the genesis of a film project. The prior summer, both law clerks worked for First Firm, which represents Studio. In interviewing the law clerks, Second Firm learns that while employed by First Firm, Law Clerk A billed approximately 100 hours on investigating the origins of the film project in question, sitting in on a meeting with the client, and related legal research. While performing these tasks, Law Clerk A reviewed confidential memoranda and documents. Law Clerk B did no work on the particular film project in question but billed 10 hours of time that was charged to Studio for Law Clerk B’s generic research on the standards for summary judgment.

DISCUSSION

A. Obligations of Nonlawyers. Nonattorney employees such as law clerks, secretaries, and investigators are not subject to the Rules of Professional Conduct. Instead, the duty of competence of members of the bar under Rule 3-110 encompasses the duty to supervise the work of nonattorney employees or agents. See CRPC 3-110 (Discussion), citing, inter alia, Waysman v. State Bar, 41 Cal. 3d 452 (1986); Trousil v. State Bar, 38 Cal. 3d 337 (1985). Attorneys are held accountable for their employees’ conduct, particularly where that conduct poses a clear threat to attorney-client confidentiality and the integrity of the judicial process. In re Complex Asbestos Litigation, 232 Cal. App. 3d 572, 603 (1991).

B. Confidentiality. Confidentiality is fundamental to our legal system.
Accordingly, Rule 3-310(E) of the California Rules of Professional Conduct prohibits attorneys from accepting employment adverse to clients or former clients “where, by reason of the representation of the client or former client, the member has obtained confidential information material to the employment,” unless the former client has given informed written consent. Under the rules, an attorney who possesses confidential information such as that obtained by Law Clerk A above would be prohibited from working on that matter or a substantially related matter at Second Firm.

If no steps are taken to screen the newly hired attorney, and attorneys in Second Firm become exposed to confidential information of the adverse party, disqualification of Second Firm might result, because where one attorney is disqualified from representation because of a conflict, the disqualification generally extends to the entire firm.  Flatt v. Superior Ct., 9 Cal. 4th 275, 283 (1994).1

It is important to emphasize that this opinion deals with the ethical obligations of the lawyers in Second Firm, not the legal standards for disqualification. However, disqualification is one of the potential consequences of an ethical violation and thus is relevant for consideration. In the context of a disqualification motion, the California Court of Appeal has held that “an inflexible presumption of shared confidences would not be appropriate for nonlawyers,” because their “training, responsibilities, and acquisition of a conflict, the disqualification generally extends to the entire firm. Flatt v. Superior Ct., 9 Cal. 4th 275, 283 (1994).3

When a hiring firm determines that a new hire or prospective employee has been exposed to confidential information likely to be material to a matter at the new firm, one option is to seek the consent of the former employer before making the hire.  (See, e.g., Complex Asbestos, 232 Cal. App. 3d at 593 n.9 (suggesting consent and noting that Rule 2-100 would preclude the hiring attorney from soliciting the consent directly from the opposing party)).

If consent is not available, the hiring firm can fulfill its obligation to ensure that its employees comply with duties of confidentiality by obligating the new hire to refrain from divulging confidential information and by screening the new hire, so that the new hire cannot provide or receive information regarding the matter from which he or she is screened. Elements of an adequate screen include written notification to all legal staff to isolate the screened employee from communication regarding the matter, prevention of the screened employee’s access to the relevant files, admonishment of the employee not to discuss the prior matter with the new firm, and a search of the firm’s records to ensure that all cases on which the new employee’s former firm is opposing counsel are identified.  Complex Asbestos, 232 Cal. App. 3d at 593-94, 596.4  The committee believes that electronic security is also an important element of an effective screen. Electronic files should be password-protected and the password withheld from screened employees. Effective practices may also include documenting the continued existence and impermeability of the screen, for example by periodic electronic or written reminders to all staff or by requiring periodic certification by screened staff that they have not breached the screen.

A similar conclusion regarding the appropriateness of screening has been reached by the American Bar Association and ethics authorities in several states, in some cases even before screening was accepted for attorneys.  See, e.g., ABA Inf. Op. 88-1526 (1988) (law firm hiring opposing firm’s former paralegal can avoid disqualification by screening paralegal and admonishing paralegal against disclosure of any information related to representation of former firm’s clients); N.Y. Eth. Op. 774 (2004) (law firm hiring nonlawyer must remind nonlawyer to protect confidential information from prior employment and must instruct its lawyers not to seek or accept confidential information if nonlawyer fails to comply with this instruction); Fl. Eth. Op. 86-5 (1986) (hiring firm has duty not to seek or permit disclosure by nonlawyer of confidence or secrets of opposing firm’s clients).5

CONCLUSION

With regard to the fact scenarios above, the committee believes that Second Firm must screen Law Clerk A from any involvement in matters adverse to Studio that are substantially related to the work that Law Clerk A performed at First Firm the previous summer. The actions of sitting in on a client meeting and investigating the origins of the particular film project will have imparted confidential information to Law Clerk A that Law Clerk A must not share with Second Firm. Second Firm must therefore admonish Law Clerk A not to share any information about his or her work in the matter, must screen Law Clerk A from any involvement on related matters in which First Firm’s clients are adverse to Studio, and must admonish all others in Second Firm not to discuss such matters with Law Clerk A.

The committee does not believe that screening of Law Clerk B is necessary. Where a nonlawyer employee worked only a minimal number of hours on a matter, researched only general points of law, and was not exposed to confidential information, there is no presumption that confidences were acquired, and therefore no need to screen that employee in subsequent employment. C.F. H.F. Ahmanson & Co. v. Salomon Bros., Inc., 229 Cal. App. 3d 1445, 1455 (1991) (in determining whether disqualification is required, court should take “pragmatic approach,” focusing on the nature of the former representation, including the nature and extent of the attorney’s involvement). However, screening of Law Clerk B might assist Second Firm in defending a motion for disqualification, should one be brought, and therefore may be prudent, even if not required. Moreover, the efficacy of a screen to avoid vicarious disqualification will be assessed on a case by case basis. Kirk, 183 Cal. App. 4th at 811. Thus, the timing of the establishment of the nonlawyer employee’s screen and the adequacy of its procedures
weigh heavily in the determination whether or not a lawyer has complied with his or her ethical duties as to supervision and maintaining confidentiality.

Finally, the committee believes that when a firm hires a nonlawyer who will be screened from involvement on a client’s matter, and consent from the nonlawyer’s former firm is not obtained, the hiring firm has a duty under Rule 3-500 to inform the client of that development because of the possibility of a disqualification motion based upon the hire.

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

1 The discussion of nonlawyer employees does not include paralegals, for purposes of this opinion, as paralegals are subject to the same confidentiality requirements as attorneys under the provisions of Business & Professions Code §6453.

2 In this opinion, and consistent with Proposed California Rule of Conduct 1.01(c), the term “firm” is used inclusively to refer to a law firm, a legal services organization, or the legal department of a government, corporate, or other organization.

3 The court of appeal has recently held that Flatt does not mandate automatic vicarious disqualification, and that there is instead a rebuttable presumption that an attorney’s knowledge of client confidences is imputed to the new firm. The presumption may be rebutted by evidence that the new firm adequately screened the new attorney. Kirk v. First Am. Title Ins. Co., 183 Cal. App. 4th 776, 801 (2010).

4 The committee notes that a nonlawyer may be subject to contractual confidentiality obligations and should have been instructed by his or her former firm as to these obligations prior to departure. This opinion does not deal with the obligations of the firm from which a nonlawyer departs.

5 The court of appeal recently elaborated further on the elements of an effective screen for attorneys, including “(1) physical, geographic, and departmental separation [], (2) prohibitions against and sanctions for discussing confidential matters; (3) established rules and procedures preventing access to confidential information and files; (4) procedures preventing a disqualified attorney from sharing in the profits from the representation; and (5) continuing education in professional responsibility.” Kirk, 183 Cal. App. 4th at 810-11. The committee believes the same elements, other than prevention of profit-sharing, are applicable to nonattorney personnel.

6 The committee is aware of ethics opinions and case law in some states suggesting that the professional rules applicable to lawyers should apply to nonmembers but rejects that standard in favor of the principles set forth in Complex Asbestos and this opinion. See, e.g., Mich. Ethics Op. RJ-115 (1992) (rules for disqualification of law firms based on lawyers transferring employment apply equally to transfers of nonlawyer employees); Williams v. Trans World Airlines, 588 F. Supp. 1037, 1044 (W.D. Mo. 1984) (disqualification standard for attorneys and secretaries should be the same). Compare Complex Asbestos, 232 Cal. App. 3d at 593 (“There are obvious differences between lawyers and their nonlawyer employees in training, responsibilities, and acquisition and use of confidential information. These differences satisfy us that a rebuttable presumption of shared confidences provides a just balance between protecting confidentiality and the right to chosen counsel.”).
Most real estate appraisals are performed as credit support for secured residential loans. Since the crisis in the housing market, appraisers have found themselves under heightened scrutiny for their role in mortgage loan generation, with particular focus on their precrisis valuations. This has led to an increase in claims made against appraisers. Their risk of liability turns on a number of factors, including the type of appraisal, the contractual relationship (or lack thereof) between the claimant and the appraiser, and the real estate appraisal standards applicable on the date of the appraisal.

In the aftermath of the savings and loan crisis of the 1980s, appraisers formed the Appraisal Standards Board to articulate and publish the generally accepted standards and rules for developing an appraisal and reporting the results of an appraisal. These standards, as interpreted and amended in the years since their original publication, are known as the Uniform Standards of Professional Appraisal Practice (USPAP).

Under California law, USPAP is the generally accepted and recognized standard of appraisal practice and serves as the foundation for arguments on the standard of care. California requires licensed appraisers to be regulated under USPAP. For federally regulated transactions—which most lender-issued mortgage loans are—appraisers have to perform their appraisals in accordance with USPAP, which provides guidelines on developing and reporting the appraisal. USPAP also addresses other types of written appraisals.

Solving for Market Value
USPAP defines an appraisal as “the act or process of developing an opinion of value....” The appraiser is “one who is expected to perform valuation services competently and in a manner that is independent, impartial...

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and objective.” The opinion of value in most residential appraisals is based on market value. Market value is defined as “a type of value, stated as an opinion, that presumes the transfer of a property...as of a certain date, under specific conditions set forth in the definition of the term identified by the appraiser as applicable in an appraisal.”

Appraisers preparing appraisals for residential mortgage loans typically are required to use standard forms that have been created by secondary lender Fannie Mae/Freddie Mac. Different forms apply depending on whether the property is, for example, a single-family residence, a multifamily property, a condominium, a mobile home, or vacant land. In appraising a single-family residence, the applicable form is the Freddie Mac Form 70 March 2005/Fannie Mae Form 1004 March 2005. (Fannie Mae/Freddie Mac are collectively referred to as a government-sponsored enterprise or GSE, and the form is typically called a GSE form.)

During the real estate boom of 2002 through 2007, lenders increasingly relied on the opinion of value in the GSE form to issue mortgage loans. These lenders also made loans that required no verification of the borrower's income or assets. Instead, the lender's credit decision relied on an appraised value that was for a specific date, typically the date the appraiser saw the property. In a time of steadily rising real estate values, lenders did not always consider what would happen if a buyer defaulted and the value of the property declined.

In the years after 2007, however, real estate values have declined, borrower defaults have increased, and lenders have faced losses. To try to recoup those losses, lenders made claims against appraisers mainly for the “inflated” values provided in appraisal reports. Borrowers have also brought similar claims against appraisers, contending that because the property value was inflated when the loan was issued, they were issued an inflated loan that they could never repay.

In defending against these claims, it is important to emphasize the definition of “market value,” particularly on a specific date. Although the claimants typically contend that the appraised value was inflated at the time the appraisal was made, in many instances the evidence for that claim is the fact that years after the loan was made, the property value is significantly lower. However, an appraisal is an opinion of value on a certain date, not a representation that the value will be stable.

In a more recent twist, borrowers claim that they cannot refinance their loan because the appraised value of their home is too low. Either the loan being refinanced is more than the property value or it cannot meet the loan-to-value ratio required by the lender. Similarly, some recent claims against appraisers are brought by sellers of properties asserting that they lost the sale of a property because the appraiser’s opinion of value was not equal to or more than the purchase price. Attorneys defending appraisers against these claims therefore should emphasize the market data available prior to the date of the appraisal as well as the definition of “market value.”

Complaints against appraisers frequently contain causes of action for negligence, negligent and intentional misrepresentation, fraud, breach of contract (brought by either a contracting party or an alleged intended third-party beneficiary), civil conspiracy, and violation of various consumer protection acts. Negligence and negligent misrepresentation appear to be the most hotly contested.

**Negligence**

To prevail on a negligence claim, the claimant must show duty, a breach of that duty, a proximate causal connection between the negligent conduct and the resulting injury, and loss or damage resulting from the negligence. Duty is often a critical element litigated in cases against appraisers. Appraisers provide opinions of value and as such are considered to be “professional information suppliers.” Under California law, a professional information supplier owes a duty only to the client, not third parties. The client is the particular person, or class of persons, that the appraiser “knows with substantial certainty...will rely on the representation in the course of the transaction.”

To determine whether the appraiser owes a duty to the claimant, the attorney defending the appraiser should first examine the engagement letter or appraisal order. The client and any intended users of the appraisal report should be clearly noted. If, for example, the plaintiff is the borrower, but the lender is the listed client, the defense attorney may argue that the appraiser owed no duty to the borrower. USPAP defines an intended user as “the client and any other party as identified, by name or type, as users of the appraisal...by the appraiser on the basis of communication with the client at the time of the assignment.”

Attorneys defending appraisers should also be aware of a software issue that has arisen on the GSE forms. Some of the software companies used by appraisers to input data onto the required GSE forms continue to include “client/borrower” on the captions on the top of the ancillary pages (the photo page, addenda page, map page, etc.). Borrowers have argued that this form language shows that the appraiser’s client is the borrower. Attorneys defending appraisers should be ready to explain that this is a software issue that an appraiser is not able to change and that should not be binding on the appraiser.

Although a third party, usually the borrower, may bring a negligence cause of action against the appraiser, only the client who retained the appraiser, or an intended user of the appraisal report, can succeed. Borrowers may claim that the appraiser owes a duty to them because they paid for the appraisal, but under USPAP, payment does not change the client relationship.

Another area of focus for defending appraisers should be the appraisal report’s limiting conditions and certifications, which protect the appraiser from liability and serve to warn the client what information is and is not included in the appraisal report. Some of these conditions include:

- The appraiser is not responsible for legal matters that affect the property.
- The sketch is approximate.
- The appraiser is not a surveyor or a home inspector.
- The appraisal was made under USPAP.

Many of these conditions can be a defense against complaints regarding such issues as surveying, home inspection, construction defects, measurement errors, and encroachments. In preprinted addenda, the GSE forms include many of these conditions limiting the extent of the appraiser’s duty.

After duty, another typical issue is reasonable standard of care. With this issue, the best defense is a good offense. When the appraisal is difficult to defend, contributory negligence can help. Defense attorneys may argue that lenders failed to protect themselves. For example, did the lender comply with its own underwriting criteria? The criteria may have required that the lender obtain an appraisal review (a summary review of the appraisal report by another appraiser) prior to making the loan. Another question is whether the lender adequately verified that the borrower could repay the loan. Loan underwriting experts can be retained to point out red flags in the loan file that were ignored. For example, did the lender question the manicurist showing a monthly income of $15,000 on the loan application? Does evidence appear in the loan file that the lender sought any verification from IRS statements that $15,000 per month was normal for the applicant? Negligent underwriting that is not the fault of the appraiser can obtain a favorable outcome for the defense at trial or mediation.

Another defense may involve a battle of appraisal experts on the issue of whether the appraiser followed the standard of care under USPAP. Was the valuation reasonable, based on the comparable sales selected, the adjustments made, and the limiting conditions cited?
If so, the appraiser fulfilled his or her duty. Finally, appraiser defense attorneys may argue that there is no proximate causation. An attorney can argue that it was not the appraisal report that caused the loan to default. Rather, it was the failure of the borrower to make payments as promised. Because the appraiser is not the proximate cause of the lender’s loss, the negligence claim fails.

**Negligent Misrepresentation**

A species of the tort of deceit, negligent misrepresentation is distinct from negligence. The elements of negligent misrepresentation are 1) the defendant made a representation of an important fact, 2) the representation was not true, 3) the defendant made the representation without any reasonable ground for believing it to be true, 4) the representation was made with the intent to induce reliance, 5) the plaintiff acted in justifiable reliance upon the representation, and 6) there was a loss.

For an appraiser, negligent misrepresentation is typically more difficult to defend against than negligence, because of the ambiguity of which third-party plaintiffs may be legally entitled to bring a claim. Unlike negligence claims, a third party who is neither the client nor a specifically identified intended user can still sue for negligent misrepresentation if the third party can show that it belongs to a particular class of persons to whom or for whom the representations were made. When the appraiser’s client was a lender, this third party is often another lender that purchased the loan.

The appraisal agreement (or the order and limiting conditions in the appraisal report) can help the defense by specifically naming the client and all intended users. If the plaintiff’s name does not appear on the agreement, the argument can be made that there was no reasonable belief that the plaintiff would rely on the report.

The GSE forms, however, contain a preprinted certification that damages this defense. Certification 23, which was added on the GSE form in March 2005, arguably undermines an appraiser’s argument that reliance is limited to only the named intended users. The certification reads:

The borrower, another lender at the request of the borrower, the mortgagee or its successors and assigns, mortgage insurers, government sponsored enterprises, and other secondary market participants may rely on this appraisal report as part of any mortgage finance transaction that involves any one or more of these parties.

This certification is often part of the contentions in complaints. A defense argument that boilerplate should not be given more weight than the specifically named users in the appraisal report is sometimes not enough to persuade the trier of fact. This warning also applies to the issue of the words “client/borrower” appearing in the captions of the ancillary pages of the GSE appraisal forms.

Assuming that the plaintiff is able to successfully establish that he or she belongs to a class that can rely on the appraisal, the next potential defense for an appraiser centers on the requirement that the misrepresentation be one of fact. An appraiser can argue that his or her opinion of value is an opinion, not a fact, and that the appraiser believed that opinion to be true at the time. After this defense is presented, another battle of the appraiser experts is likely to ensue about the value of the property, the comparable sales selected, and the adjustments made.

Defense attorneys should be aware, however, that in California, contributory negligence is usually not a defense against negligent misrepresentation. However, the same facts that may establish contributory negligence may be used to prove that the reliance was unreasonable. An appraiser’s defense attorney can argue that reasonable and prudent underwriting was ignored by the lender. Similarly, the defense can argue that there is no proximate cause, since the lender’s loss is from further obligations under the defaulted note. As such, after a full credit bid, the lender cannot pursue any other remedy regardless of the actual value of the property on the date of sale. Thus the lender is precluded from collecting its debt from an appraiser by claiming that the property was actually worth less than the bid. Few full credit bids are made, but when they are, this defense is typically successful.

Another defense issue is insurance policy limits, which come into play in settlement negotiation and trial. As housing values rose, many appraisers did not raise their insurance policy limits. Appraisers may still have a policy limit as low as $300,000, which was adequate when housing values in many local markets ranged no higher. During the bubble, that range was more often exceeded, exposing appraisers to liability in excess of policy limits. Settlement talks therefore take policy limits into consideration. Most errors and omissions insurance policies have diminishing limits in which the defense fees and costs from further obligations under the defaulted note are covered.
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are counted against the policy limit. The insurance carrier therefore has to weigh the cost of defense against exposing the appraiser to a judgment at trial.

The Dodd-Frank Act

The defense tactics described above apply to appraisals written between 2003 and 2008 under the guidelines in place at that time. The recent mortgage meltdown, however, has resulted in new rules for appraisers, and these rules are for the most part untested in court. In March 2008, for example, Freddie Mac, the Federal Housing Finance Agency, and the New York State Attorney General issued the Home Valuation Code of Conduct (HVCC) to enhance the independence and accuracy of appraisals.28 The purpose of this new standard is to maintain a separation between risk management and loan production. This has resulted in the rise of Appraisal Management Companies (AMCs), which act as intermediaries between the lender and the appraiser. To protect themselves, AMCs often have contracts that include the appraiser’s agreement to indemnify the AMC should a claim be filed. Appraisers are advised not to sign these contracts, which increase their exposure to liability. Most errors and omissions insurance carriers for appraisers do not cover such claims. The era of the HVCC appears to have ended, however, with the Dodd-Frank Act,29 which went into effect in November 2010.

That act includes many of the provisions that appear in the HVCC and is still undergoing scrutiny. The act requires anyone reviewing appraisals to file a state board complaint against any appraiser who has prepared an appraisal report that appears to be below the standard of care.30 Many appraisers are critical of this measure for being overbroad and lacking due process. Should someone who knows little about appraisals, such as a borrower, be obliged to file a state board complaint? Other potential claimants are reviewers of appraisals, who often are competitors of the appraiser they are reviewing. Some appraiser reviewers are from a state in which the property is not located and have little knowledge about the area in question. Under what criteria should they file a complaint and interfere with the appraiser’s business? While waiting for the state board’s findings, an appraiser can lose a substantial amount of work, especially since many lenders will not give assignments to appraisers with a record of a state board complaint. A state board complaint also costs money to defend, and the stakes are high, since an unsuccessful outcome can cause a civil action to be filed against the appraiser.

Although it is unknown how exactly the Dodd-Frank Act will affect appraiser liability, it appears that appraisers are likely to face more claims in the future. Appraisers need to remain current with the legislation, statutory codes, and appraisal forms and software in order to be able to better defend their appraisals and opinions of value. This will take detailed work files and adding more limiting conditions and certifications that specifically address all issues and conditions affecting each appraisal report. With that, attorneys can better defend their appraiser clients.
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The slowdown in consumer spending that started with the recent recession continues to have a ripple effect in the commercial real estate industry. Developers find themselves without the capital to complete new projects, lenders and investors lose confidence in the ability to lease new projects, retailers are unable to sustain the high rents to which they committed when sales were higher, and property owners face increasing vacancies and nonperforming tenants. Indeed, tenants are seeking protection under the bankruptcy rules with such frequency that many practitioners, including traditional real estate lawyers, have found it necessary to expand the laws with which they are generally familiar to include certain aspects of the Bankruptcy Code.

With continuing frequency, commercial property owners must calculate their expected damages and determine how those damages may be limited when tenants breach their leases by rejecting them in bankruptcy. While bankruptcy practitioners are familiar with the statutory formulas and case law for these issues, nonbankruptcy lawyers with experience representing owner clients in real estate transactions may feel unprepared to advise the owners on what steps to take when they have a tenant who has filed for bankruptcy protection or is threatening to do so in order to gain leverage in a negotiation.

Real estate practitioners representing owners with tenants who have filed for protection under the bankruptcy laws must become familiar with Bankruptcy Code Section 502(b)(6). This section imposes a somewhat confusing, and often misinterpreted, cap on the damages that a landlord may recover when a tenant breaches its lease by rejecting it in bankruptcy. Counsel must also grasp two additional issues important to landlords when a tenant files for bankruptcy. The first involves determining whether expenses

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allocated to the tenant under the lease—such as property taxes and insurance costs—are affected by the statutory cap on damages imposed by Section 502(b)(6). The other requires an assessment of the effect on damages of a security deposit.

Section 365 of the Bankruptcy Code provides that parties in bankruptcy have the right to assume or reject their executory contracts and unexpired leases, subject to bankruptcy court approval. The tenant’s election to reject an unexpired lease constitutes a breach of the lease, which vests in the landlord a prepetition unsecured claim for damages. The landlord files a claim for damages in bankruptcy court. The court, applying state law, determines the amount of damages based on the terms of the lease or contract between the landlord and the debtor tenant.

Statutory Cap
When the debtor or a competing creditor objects to the amount of the landlord’s claim, Section 502(b)(6) imposes a cap on the amount of the recoverable damages. The cap limits the landlord’s claim against the debtor’s estate to the extent the claim exceeds the sum of “(A) the rent reserved under the lease, without acceleration, for the greater of one year or 15 percent, not to exceed three years, of the remaining term of the lease, and (B) any unpaid rent due under the lease.” The date on which the reserved rent damages under subsection (A) start to accrue and on which the unpaid rent under subsection (B) is measured is the earlier of the date the tenant files its bankruptcy petition or the landlord regains possession of the premises.

The policy behind the decision by Congress to limit a landlord’s damages following rejection of a commercial lease can be traced to well before the Bankruptcy Reform Act of 1978. Legislative history reveals that Section 502(b)(6) was designed to not only compensate a landlord fairly but also to make sure the landlord’s claim did not prevent other unsecured creditors from recovering from the estate—particularly when the lease has a long term remaining when the tenant files for bankruptcy protection. Congress identified two major reasons for the need to limit a landlord’s claim. First, the failure to do so would limit disproportionately the recovery of other creditors. Second, a landlord is not in the same position as other creditors, because usually the landlord is compensated until the date of the tenant’s filing for bankruptcy, and the landlord regains possession of the property following the bankruptcy.

In considering the Bankruptcy Code’s limitation on a landlord’s claim, it is important to consider what Section 502(b)(6) does not do. Section 502(b)(6) does not provide a formula for calculating damages under a lease. Nor does it establish what constitutes an allowable claim for a landlord. A landlord need not comply with any of the requirements of Section 502(b)(6) in order to file a claim in a bankruptcy proceeding. But once a landlord’s damages following a breach by the debtor are calculated, Section 502(b)(6) is used to determine whether the amount of the claim should be limited because it “exceeds the cap calculated under the statute.”

In California, the landlord, following the tenant’s breach, is entitled to recover all unpaid rent at the time of the breach as well as the present value of the amount by which the unpaid rent for the remainder of the lease term exceeds the amount of lost rent that the tenant proves could reasonably be avoided through leasing the premises to another tenant or other mitigation measures. The landlord also may recover additional amounts necessary to compensate it for the tenant’s failure to perform other duties under the lease, such as the obligation to maintain or restore the property to a specified condition or payment of property taxes. Accordingly, when faced with a tenant’s rejection of its lease in bankruptcy, an owner of California property must first apply nonbankruptcy law and determine the amount of its unpaid rent and lost rent due to the breach and thereafter determine in what way, if any, Section 502(b)(6) limits those damages by imposing a cap.

Time versus Rent
Bankruptcy Code Section 502(b)(6) expressly limits a landlord’s claim to the greater of “one year, or 15 percent, not to exceed three years, of the remaining term of such lease.” This language is subject to two interpretations. If the remaining term at the time of the breach exceeds one year, does the “or 15 percent” limitation require measurement of the time remaining on the lease or the amount of rent “reserved by such lease”? Courts have had trouble agreeing on how to answer this question, and the varying results can be meaningful if the rent increases over the remainder of the term of the lease, or the lease contains significant free rent periods that affect the timing of rental payments.

The fact that courts are split on the question of whether the 15 percent cap applies to the remaining rent “reserved” under the lease or the time remaining under the lease (to which the rental rate is then applied) suggests that the language of the statute is unclear on this issue. The language of Section 502(b)(6) implies, however, that the time remaining on the lease—not the remaining rent—should be measured.

A reading of the statute that involves removing the “not to exceed three years” clause—which establishes the maximum period of rent to be awarded—results in an unambiguous reference to time. The statute limits a landlord’s claim against the breaching tenant to the extent the claim exceeds the rent reserved under the lease for “the greater of one year, or 15 percent...of the remaining term of [the] lease.” Indeed, courts that have looked to the plain meaning of the statute to answer the “time versus rent” question have determined that the clause refers to the time remaining on the lease. Under this interpretation, after calculating the length of 15 percent of the remaining term, the rent in effect during that period is applied. Although the Ninth Circuit has not squarely addressed the issue of time versus rent, in applying Section 502(b)(6) the court has measured the time remaining on the lease to determine the maximum recovery available to a landlord when the cap is applied. An additional indication that the cap imposed by Section 502(b)(6) is intended to measure the time remaining on the lease and not the total rent reserved is the frequently used method for determining whether the cap is governed by the one-year limitation or, alternatively, the limitation of 15 percent, not to exceed three years, of the remaining term. The court in In re Iron-Oak Supply Corporation noted that the statute enables the bankruptcy court to determine the number of months of rent that can be claimed as damages by looking to the remaining term of the lease following the earlier of the filing of the bankruptcy petition and the surrender of the leased premises. If less than 80 months remain on the term of the lease, then the one-year cap will apply (15 percent of 80 months is one year). If more than 80 months and less than 240 months remain, then the 15 percent limitation will apply (15 percent of 240 months is three years). If the lease has more than 240 months remaining, then the statute limits the landlord’s claim to three years of rent. According to the Iron-Oak Supply court, the reference in the statute to the remaining number of months in the lease indicates that “Congress intended...the phrase ‘remaining term’ be a measure of time, not rent.”

Further support of this reading of the statute is Section 502(b)(6)(A)’s reference to the rent reserved by the lease “without acceleration.” That phrase only has meaning if it is referring to the next succeeding periods under the lease—whether one year or 15 percent of the remaining term, whichever is greater—so long as the total claim is capped at three years. If Congress had intended for the rent to be calculated based on the remaining rent due, and not the length of the term...
lease by threatening to file bankruptcy enables the landlord to terminate that lease.

True. False.

2. Bankruptcy Code Section 502(b)(6) provides a formula for calculating damages under a lease.

True. False.

3. Section 502(b)(6)'s cap on damages limits a landlord’s recovery when the rent per square foot exceeds the statutory minimum.

True. False.

4. A tenant in bankruptcy rejects a lease with 22 years remaining on the term, the landlord’s damages will be limited to three years' rent.

True. False.

5. Section 502(b)(6)’s reference to the rent reserved under the lease “without acceleration” is evidence that the statute’s limit on the landlord’s damages is intended to measure time, not remaining rent.

True. False.

6. Though courts are split on whether the 15 percent limitation on rent requires a measurement of rent or the remaining term of the lease, the distinction is ultimately unimportant to determining the landlord’s damages.

True. False.

7. Courts that have determined that measuring the total rent remaining under the lease rather than time is the better interpretation of Section 502(b)(6) have not identified compelling reasons for this conclusion.

True. False.

8. A landlord may try to argue that expenses allocated to the tenant under the lease are not “rent” in order to avoid having those expenses subject to the Section 502(b)(6) cap.

True. False.

9. A tenant that contaminates a property may receive an unintended windfall by invoking the Section 502(b)(6) cap on damages.

True. False.

10. The Ninth Circuit’s test for whether the landlord’s damages are limited by the Section 502(b)(6) cap is whether the damages were the result of the lease rejection or some other event.

True. False.
remaining, then it would not have added the “without acceleration” language to the statute. Calculating the remaining rent due has the same economic effect as an acceleration of the lease.15

Thus, the statute is best interpreted to cap the amount of time that remains on the lease. Once 15 percent of the number of months remaining on the lease is determined, Section 502(b)(6)(A) caps the landlord’s claim for future rent at the amount of rent that would have become due during that period.16 If any free or reduced rent is applicable to that period, then those aspects of the lease will serve to limit the landlord’s allowable claim.

Nonetheless, despite the arguments for why the cap on damages imposed by Section 502(b)(6) is best interpreted as referring to the time remaining under the lease, the majority of cases that have considered the issue have reached the opposite conclusion. These courts have interpreted “15 percent of the remaining term [of the lease]” to mean “15 percent of the net amount of rent, after subtracting amounts received in mitigation, due for the remaining term.”17 Thus, the majority view is that the “or 15 percent” limitation quantifies the aggregate rent remaining under the lease and not the time remaining.18

Courts applying a “total rent remaining” theory have identified compelling reasons for focusing less on the words of the statute in reaching the desired result. After all, a strong argument can be made that the landlord is not unjustly benefited by receiving the higher amount, because the landlord is collecting a portion of the increasing rent that it bargained for in the lease. Courts have also noted that in a lease the landlord retains the risk of fluctuations in the value of the property. At the conclusion of the lease, the tenant has no risk associated with a decline in value.19 One factor that can affect that fluctuation in value is the bankruptcy of one or more tenants. Since landlords assume the risk of value and bankruptcy, they should not be deprived of any bargained-for increases in rent during the term of the lease.

**Limits on Non-Rent Obligations**

Once a commercial landlord calculates its damages in the form of lost rent, and any limitation on those damages imposed by the Bankruptcy Code, the landlord must next consider whether the Section 502(b)(6) cap applies to any other damages that may have resulted from the breach. Since the Bankruptcy Code limits the landlord’s recovery following the rejection of the lease to the “rent reserved” by the lease for the time periods specified in Section 502(b)(6), an initial question is whether expenses that are contractually the tenant’s obligations—but may not be considered rent—are subject to the Section 502(b)(6) cap. Examples of these types of expenses are property taxes, insurance, maintenance, and repair costs.

A landlord seeking to avoid the limitations imposed by the cap might contend that expenses allocated to the tenant under the lease are obligations independent of the covenant to pay rent and therefore are outside the scope of Section 502(b)(6). A second, and related, argument is that these kinds of expenses—which are contractually the tenant’s responsibility—are, to the extent they are delinquent at the time of the bankruptcy filing, outside the scope of Section 502(b)(6) because they do not arise “from the termination” of the tenant's lease.20 If the tenant’s obligations, such as its share of property taxes or maintenance expenses, are delinquent at the time of bankruptcy, those obligations do not arise from the termination of the lease and arguably should not be limited by the statutory cap.

While there is some division among bankruptcy courts on the issue of whether non-rent expenses are subject to the cap imposed by Section 502(b)(6), the majority of courts, including the Ninth Circuit Bankruptcy Appellate Panel, have held that a tenant’s breach of its non-rent obligations should be treated no differently from damages resulting directly from the tenant’s rejection of the lease.21 The Bankruptcy Code suggests that there is no distinction between past obligations, such as failure to pay property taxes, and damages caused by the termination of the lease, because all damages due to the tenant’s nonperformance are encompassed by the Section 502(b)(6) cap.22 This would also include covenants that may have been violated before the date of rejection.

However, the analysis should be different when the tenant commits a tort against the property, such as waste, nuisance, or trespass. When the landlord suffers damages that are collateral to the purpose of the lease, and are not based on lost rent or damages directly arising from a tenant’s failure to perform an obligation specified in the lease, these damages do not “result from” the rejection of the lease and are not subject to the cap.23

The Ninth Circuit’s test for determining whether the landlord’s damages were the result of the lease rejection and therefore limited by Section 502(b)(6) is whether the landlord would have the same claim against the tenant if the tenant were to assume the lease rather than reject it.24 If the landlord would have the claim against the tenant even after the tenant has cured the defaults and performed the covenants necessary to assume the lease, then the cap does not apply—but if the landlord’s claim arises only upon lease rejection, then the damages are subject to the statutory cap.

This rule properly aligns the tenant’s incentives. If Section 502(b)(6) were held to limit a landlord’s claim when the tenant has done collateral damage to the property, the tenant may have an incentive to reject the lease to avoid paying the full amount of damages it has caused. This is so even when performing under the terms of the lease would otherwise be desirable to preserve the value of the tenant’s business.25

If the landlord is unable to convince the court that Section 502(b)(6) should not apply because its damages are collateral to the terms of the lease, the landlord should then try to expand the universe of items that entail “rent reserved” by the lease. In this way, the landlord increases its potential recovery because the limitation to one year’s rent, or 15 percent of the remaining term of the lease, whichever is applicable, would be based on a larger pool of funds to which the cap is then applied.
It would include not only traditional rent but also other tenant obligations—such as taxes, insurance, and maintenance costs—that are generally considered necessary to maintain the value of the property.

The Ninth Circuit has adopted a three-prong test to determine whether a charge under a lease is rent reserved and thus included within the one or three years’ rent to which the landlord is entitled. First, the charge under the lease must be designated as “rent” or “additional rent” in the lease or deemed the tenant’s obligation under the lease. Second, the charge must be related to the value of the property or the lease on the property. Third, the charge must be properly classifiable as rent because it is fixed, regular, or periodic. Thus property taxes and insurance premiums are likely to qualify as rent if they are the tenant’s obligation. By contrast, a one-time maintenance fee would not satisfy the third prong of the test and would not be considered rent reserved when calculating the landlord’s damages. A landlord should expect its recovery to be limited to one year’s rent, or 15 percent of the remaining term, as applicable, and should base the 15 percent test on all “rent” as established by the Ninth Circuit’s three-prong test.

**Security Deposits**

The delivery of a security deposit under the lease is a separate but related issue that also arises following the rejection of a tenant’s lease in bankruptcy. The bankruptcy court must decide if the security deposit should be used to offset the landlord’s total damages before the application of Section 502(b)(6) or should be taken into account after the cap has been applied to further limit the landlord’s claim. A landlord holding a claim against the debtor’s estate would prefer a method in which the first step is calculating the gross damages under the lease, and next the amount of the security deposit held by the landlord is subtracted from the gross damages. That sum would be compared to the cap imposed by Section 502(b)(6)—and the landlord’s claim would be the lesser of the two. This calculation makes intuitive sense if the purpose of the Section 502(b)(6) cap is to limit the landlord’s damages.

However, the debtor—or the debtor’s creditors other than the landlord—would prefer to subtract the security deposit after the court determines the landlord’s damages under the Section 502(b)(6) cap. The landlord’s damages under nonbankruptcy law would be compared to the capped amount under Section 502(b)(6), and then the security deposit would be subtracted from the lesser of the two. Determining whether this preference by debtors should prevail cannot be discerned by referring to the plain language of the statute.

Courts that have considered the application of a security deposit held by the landlord have largely relied on legislative history and a Second Circuit decision, *Oldden v. Tonto Realty Corporation*, that predates the Bankruptcy Reform Act of 1978 by more than 30 years. The *Oldden* court considered whether a landlord who held a cash security deposit was required to deduct the amount of that deposit from the total damages provided by the lease or from the total allowable claim under the then-existing Bankruptcy Code. The court concluded that the security deposit should be deducted from the allowable claim rather than the total damages.

Congress endorsed this holding when it enacted the 1978 act and indicated that the new Bankruptcy Code Section 502(b)(6) was not intended to overrule *Oldden*. Noting that the purpose of the cap on a landlord’s damages is to “compensate the landlord for [its] loss while not permitting a claim so large...as to prevent other general unsecured creditors from recovering a dividend from the estate,” Congress expressly stated that a landlord’s security deposit “will be applied in satisfaction of the claim that is allowed under [Section 502(b)(6)]”—the same determination under *Oldden*. Much to the dismay of a landlord who takes comfort in having had the foresight to secure a large deposit from its now bankrupt tenant, courts have almost unanimously determined that the full amount of a security deposit should reduce the landlord’s allowable claim in bankruptcy and not be subtracted from its gross damages.

Nevertheless, the possession of a security deposit is not without benefit to a landlord. Even though the security deposit does not expand the universe of damages that the landlord might otherwise receive after application of the statutory cap, a security deposit ensures that the landlord will receive 100 percent recovery on that portion of its claim that is held in the form of a security deposit. Without a security deposit, the landlord is subject to the potential limitation on recovery that all creditors face due to the inability of the debtor’s estate to compensate the creditors to the extent of their claims.

A landlord faced with a bankrupt tenant or a tenant threatening to file for bankruptcy protection faces a long and challenging road to recover its bargained-for benefits under its lease. In today’s climate of large bankruptcies filed by national tenants across the country, landlords cannot be sure whether their leases will be rejected, whether their location is one that benefits the tenant, or if the most advantageous result is to sell their unsecured claim—an option that has become commonplace in large bankruptcy cases. In order to best evaluate their course of action, landlords must first predict the amount of their allowable claim, which must then be discounted by the likelihood of recovery.

To calculate the amount of the claim, a landlord must determine its gross damages under nonbankruptcy law and determine how much, if any, the cap on damages imposed by Bankruptcy Code Section 502(b)(6) will limit that claim. Further consideration should be given to whether the landlord has any non-rent damages, and if so, whether they are also likely to be limited by the statutory cap. Finally, if the landlord holds a security deposit, it must be subtracted from the capped damages to determine the likely amount of its claim. Although numerous unknown events in the bankruptcy case may still emerge and bring their own complications, this analysis will enable landlords to be in the best position to further their interests.

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1 See 11 U.S.C. §365(g). The breach is deemed to be prepetition, so the terms of the lease govern a landlord’s damages.

2 In re McSheridan, 184 B.R. 91, 96 (B.A.P. 9th Cir. 1993), overruled on other grounds in In re El Toro Materials, 504 F. 3d 978 (9th Cir. 2007).

3 Bankruptcy Code §502(b) limits the amount of certain claims, including those by commercial landlords. See 11 U.S.C. §502(b)(6).

4 See El Toro Materials, 504 F. 3d at 980 (holding that the statutory cap does not apply to damages to the property caused by the tenant if the damages are collateral to the termination of the lease) (citing S. Rep. No. 95-989, at 63 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5849).


6 In re JSIF Corp., 344 B.R. 94, 101 (B.A.P. 9th Cir. 2006), aff’d, 277 F. App’x 718 (9th Cir. 2008).


10 For example, a tenant filing a petition for Chapter 11 protection has a lease with 12 years remaining and rent escalations every four years. The rent is $100,000 per year in years one through four; $130,000 per year in years five through eight; and $200,000 per year in years nine through 12. If the cap is interpreted as 15% of the remaining term, then the landlord’s damages would be limited to $810,000 ($10,800 per year in years one through four; $15,000 per year in years five through eight; and $21,000 per year in years nine through 12). If the cap is interpreted as 15% of the remaining term, then the landlord’s damages would be limited to $810,000 ($10,800 per year in years one through four; $15,000 per year in years five through eight; and $21,000 per year in years nine through 12). If, however, the cap is interpreted as 15% of the remaining rent reserved under the lease, not to exceed three years of rent, then the landlord would be entitled to recover $270,000 (15% of the total amount of rent reserved under the lease, which is less than three years of rent, no matter which three years are considered). Note that the presence of free rent during the period constituting 15% of the remainder of the term would make the differing results even more dramatic. See In re Allegheny Int’l, Inc., 145 B.R. 823, 828 (W.D. Pa. 1992), aff’d and remanding, 136 B.R. 396 (W.D. Pa. 1991).

11 See, e.g., In re Richard H. Flanagan, 374 B.R. 568,
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A lease with between 80 and 240 months remaining on the term will fall within the provision that caps rent at the greater of “15 percent, not to exceed three years, of the remaining term of the lease.”

87 See Iron-Oak Supply, 169 B.R. at 419.


89 See also M. TREISTER ET AL., FUNDAMENTALS OF BANKRUPTCY LAW 313 (6th ed. 2006).

90 See In re Allegheny Int’l, 136 B.R. at 402-03.

91 For example, under this interpretation, if seven years remain on the lease on the date that is the earlier of the filing of the bankruptcy petition and the surrender of the premises by the tenant, the landlord’s claim will be limited to the rent due for the next 1.05 years (15% of 7 years).

92 See Iron-Oak Supply, 169 B.R. at 419.


94 See Gantos, 176 B.R. at 795.

95 Bankruptcy Code §502(b)(6) limits a claim against the estate of a bankrupt tenant only if “such claim is the claim of a lessor for damages resulting from the termination of a lease of real property.”

96 See In re McSheridan, 184 B.R. 91, 101-02 (B.A.P. 9th Cir. 1995).

97 Id. at 102.

98 In re El Toro Materials, 504 F. 3d 978, 980 (9th Cir. 2007) (holding that the landlord’s damages resulting from the tenant allegedly leaving 1 million tons of wet clay “goo” on the property were not limited by the §502(b)(6) cap).

99 Id. at 980-81. According to Bankruptcy Code §365(b), a debtor seeking to assume the lease following a default must cure—or provide adequate assurance that it will promptly cure—the default and provide adequate assurance of future performance.

100 In re El Toro Materials, 504 F. 3d at 980-81.

101 For example, in McSheridan, the guarantors of the debtor’s lease paid $74,000 to settle the claims of the landlord under the lease. The guarantors then filed a claim against the debtor’s estate for that amount. The debtor objected, claiming the guarantors’ claim should not exceed one year’s rent under §502(b)(6)(A). The guarantors argued that other expenses—such as insurance payments, taxes, utilities, and repairs and maintenance—should be considered “additional rent” necessary to maintain the value of the premises and should be included within the definition of “rent reserved by
Singled OUT

Chapter 11 provides only temporary respite to an entity in a single asset real estate bankruptcy

The U.S. Bankruptcy Code1 was designed to handle the reorganization of operating businesses with a significant number of employees and multiple creditors. Its drafters did not envision the code as a means to resolve disputes between the owners of real property and their secured lenders. Yet during periods of declining real estate value, such as the past several years, property owners eager to delay or escape foreclosure seek shelter in chapter 11. Single asset real estate (SARE) debtors can look to Bankruptcy Code Sections 362(d)(3) and 101(51B) (the SARE provisions) to speed up their chapter 11 cases. At the same time, those sections prevent SARE debtors from using bankruptcy to wait out the market and stymie the enforcement efforts of lenders.

Even though the SARE provisions make bankruptcy a less attractive alternative for many property owners, most debtors are still finding that filing chapter 11 petitions yields more benefits than submitting to foreclosure. The goal of chapter 11 bankruptcy is to readjust the terms of the debtor’s debt obligations so it can meet them given its current financial situation and projected income. This can be accomplished in SARE cases under the right circumstances. On the other hand, diligent secured lenders can limit the amount of delay they might face in exercising their right to foreclose.

Yet another factor comes into play, however, in the context of SARE cases. While the 2005 amendments to the Bankruptcy Code are better known for their requirements making it more difficult for consumer debtors to file, they also eliminated the $4 million debt cap.2 With this change,

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the fast track rules for SARE cases began to apply to entities with properties that may be worth tens if not hundreds of millions of dollars. As a result, these rules are sweeping into their purview structured finance transactions in which the debt secured by the property is publicly tradeable, and the debt and the property are “ring-fenced” from the assets and liabilities of the borrowers’ principals and affiliates—further binding repayment to the value of the property.

Consequently, strategic investors attempting to acquire attractive assets have used the SARE provisions in that pursuit. For example, the secured bondholders in In the Matter of Scotia Pacific Company attempted to have the debtor—an owner of hundreds of acres of forest—designated a SARE entity. This would have made it practically impossible for the debtor to restructure, because the debtor could neither make interest payments on $700 million nor propose a confirmable plan within 90 days. The attempt failed, but other similar efforts are likely to ensue and may succeed.4

What Constitutes a SARE

For tax purposes, ownership of real estate is typically structured so that one entity only owns one piece of property. As the real estate market began to collapse, many single asset real estate entities not only became unable to meet their mortgage obligations but also sought Bankruptcy Code protection to prevent foreclosure by secured lenders. In a typical SARE case, as a result of the lack of an ongoing commercial enterprise and the fact that the loans were mostly nonrecourse, “the only means of loan repayment was the value of the real estate.” In California, however, it is typical for secured lenders to obtain a guaranty of the debt from the principals, parent, or affiliates of the borrower.

In response to the problems inherent in SARE cases, including the frustration of secured lenders,6 Congress enacted the SARE provisions in 1994. These include Bankruptcy Code Section 101(51B), which defines “single asset real estate,” and Section 363(d)(3), which imposes stringent deadlines on SARE debtors to either file a confirmable plan of reorganization or start making interest payments at the nondefault rate within 90 days of the filing of the bankruptcy or 30 days after the date the court designates the debtor a SARE, whichever is later.

Although the legislative history of Bankruptcy Code Section 363(d)(3) has been described as “meager,” courts have recognized that it was designed to correct the “relative unfairness of lengthy delay” in SARE cases. Moreover, the section requires that “where the case does not early kick forward toward confirmation, a debtor must compensate its mortgagee for the time-value of the mortgagee’s debt-investment, by the payment of interest at the original contractual rate.” However, motions for relief from stay are not automatically granted even when a debtor has failed to comply with the requirements of Section 363(d)(3). Nevertheless, some courts have held that Section 363(d)(3) is self-executing and that a SARE debtor must act before the SARE deadlines run.10

For real property to be deemed a SARE, Bankruptcy Code Section 101(51B) designates three mandatory factors:

1) The property must be “real property constituting a single property or project.”
2) The real property must generate “substantially all of the gross income of the debtor.”
3) The debtor cannot maintain any “substantial business” on the property “other than the business of operating the real property.”11

Bankruptcy courts consistently hold that Section 101(51B) is ambiguous and subject to different interpretations. As a result, practitioners must be mindful that a knowledge of case law prior to the enactment of the SARE provisions is essential to determining the scope of those provisions.12 Indeed, post-1994 cases continue to analyze SARE cases in much the same way previous courts did before the passage of the SARE provisions.13

Under the SARE provisions, a “single project” may constitute more than one parcel of real property, but those parcels “must be linked together in some fashion in a common plan or scheme involving their use.” The connection must be more than tactile or operational. The essential requirement is the presence of a common purpose.15

Courts have noted that “[i]t is not clear what constitutes ‘merely operating the real property’ and what constitutes other business activity.”16 The phrase “generating substantially all of the gross income of the debtor” is similarly ambiguous as it tends to merge into the requirement that there be no substantial business on the property. Nonetheless, the touchstone of SARE jurisprudence remains intact: A debtor is not a SARE when its active use of property results in revenue attributable to the operations on the property and not the property itself. Thus, practitioners must clearly assess whether a debtor client’s revenues are the product of the debtor’s land or instead derived from the entrepreneurial efforts of its employees.17

The Fifth Circuit’s Scotia Pacific Company ruling in 2007 reaches a conclusion apparently shared by all courts addressing the issue of what constitutes a SARE:

In order to be single asset real estate, the revenues received by the owner must be passive in nature; the owner must not be conducting any active business, other than merely operating the real property and activities incidental thereto. Under the prior jurisprudence, those passive types of activities are the mere receipt of rent and truly incidental activities such as arranging for maintenance or perhaps some marketing activity, or…mowing the grass and waiting for the market to turn.18

Options for Debtors

Despite the fast track file-or-pay deadline, filing a chapter 11 case still provides a SARE debtor with considerable breathing space. A property owner’s first step is to ensure that it does not meet the elements of a SARE. This can be done by: 1) commencing operations on the property (such as farming or retail operations), 2) contributing property to the entity and thus making it more than a single project (for example, transferring a parcel of property totally unrelated to the property the debtor currently owns), or 3) contributing personal property to the estate (such as stock, vehicles, or inventory). Debtors that cannot put themselves beyond the reach of a SARE designation can seek a 90- to 120-day delay from foreclosure while they pursue their alternatives. The additional time may allow a SARE debtor to accomplish a sale of the property, raise additional capital, or obtain new financing.

A significant advantage of a bankruptcy is that the sale of the real property may be “cleaner” from the buyer’s standpoint if it is accomplished with court approval as part of a bankruptcy case.19 A potential buyer may be unwilling to buy a project from a financially troubled debtor not currently within the ambit of bankruptcy because of the prospect of potential claims, including the possibility that the sale may be set aside as a fraudulent transfer.20

In a bankruptcy case, real property can be sold free and clear of liens, with the liens attaching to the sale proceeds.21 If the sale is effected pursuant to a confirmed plan, impediments that would be fatal to a transfer outside of bankruptcy—such as due-on-sale mortgage provisions or even monetary or nonmonetary defaults—can be effectively eliminated by the plan.22 Chapter 11 also offers an opportunity for the debtor to obtain new capital to fund its operations or to make improvements to its project.23

In preparation for a bankruptcy filing, a SARE debtor should conserve cash. The debtor can buy itself time beyond the 90-day deadline by making interest payments at the contract nondefault rate based on the value of the property. The cash preserved prior to filing may be the source of the inter-
est payments. If the debtor’s property generates revenue, this may be used to make interest payments to the secured lender. However, many SARE debtors do not have property that generates revenue.

When interest payments are not feasible, the SARE debtor can achieve additional time by filing a confirmable plan. What constitutes a confirmable plan is less stringent than in other contexts. In a relief from stay proceeding, the SARE debtor need not demonstrate that its plan actually will be confirmed. The debtor also is not required to present the kind of evidence that would be necessary at a confirmation hearing. Instead, the debtor need only produce some evidence that its plan could be confirmed by a reasonable bankruptcy judge.

The Bankruptcy Code permits a secured claim to be bifurcated. The secured portion of the claim is based on the value of the collateral. The other portion of the claim—the amount of the claim that exceeds the value of the collateral—constitutes the unsecured deficiency claim.

Under Bankruptcy Code Section 1129(a)(10), if the plan proposes to impair one or more classes of creditors’ claims, then the creditors behind at least one class of these impaired claims must consent to the plan for it to be confirmed. In a typical SARE case, the secured lender’s deficiency claim is the largest claim and would dominate the voting if all unsecured claims were classified in a single class. If the lender does not agree on the terms of the plan, then an accepting class would have to come from other creditors. This is a significant challenge for debtors.

Recent Ninth Circuit cases, however, give SARE debtors an advantage with regard to classifying a secured creditor’s deficiency claim separate from other unsecured claims. In the past, the separate classification of unsecured claims was considered improper when the court determined that its purpose was to “manipulate” plan voting: “Thou shalt not classify similar claims differently in order to manipulate plan voting: “Thou shalt not manipulate plan voting: “Thou shalt not manipulate plan voting: “Thou shalt not manipulate plan voting: “Thou shalt not manipulate plan voting.26 However, in In re LOOP 76, LLC,27 the court held that the debtor made a prima facie case that the significance of the guarantee of the secured creditor’s debt by the debtor’s principals rendered its claim both factually and legally dissimilar from the unsecured creditors’ claims. The court reasoned that the secured creditor “need not be concerned about whether the plan maximizes the value of the estate and the return to creditors because it is assured of payment from non-debtor sources.” Thus, the court held that the existence of guarantors was a permissible basis to find that the secured creditor’s deficiency claim was dissimilar from other claims that lack an alternative repayment source.

SARE debtors that can obtain consent from a class of creditors with impaired claims must still meet the confirmation requirements of Bankruptcy Code Section 1129. The plan cannot unfairly discriminate between the treatment of different classes of claims.28 For example, a court found that the payment of a lender’s unsecured deficiency claim without interest over 10 years was unfair discrimination, because other secured creditors were paid within six months. As a result, the plan did not account for the time value of money and the risk of nonpayment.29

The plan also must be fair and equitable. To make this finding, Section 1129(b)(2)(A) defines a “fair and equitable” plan:

1) The plan allows the secured debtor to retain its liens up to the amount of its claim and provide for payments totaling the value of its claim.
2) The plan allows the secured creditor the right to credit bid for the property on sale.
3) The plan allows for the realization of the “indubitable equivalent” of its claim.

Typically, a SARE debtor proposes deferred payments. However, the sufficiency of the interest rate is often the subject of litigation and ultimately determined by the court.

The SARE debtor’s plan must be feasible.30 Indeed, when a SARE debtor’s plan provides for payment to creditors out of the income stream generated from ongoing operations, the SARE debtor must demonstrate that the plan is not likely to be followed by a liquidation or the need for further financial restructurings. Typically, SARE debtors satisfy the feasibility requirement by demonstrating the sufficiency of rental income or sales revenue to fund continued operations and payments to creditors under the plan.31

**Procedures for Secured Creditors**

Practitioners should not discourage SARE entities from taking advantage of the many benefits provided by chapter 11. Nevertheless, all parties should remember that the SARE provisions were enacted to benefit secured creditors. As one court ruled prior to the enactment of the provisions, “[A] debtor may not use the automatic stay indefinitely as a refuge while leaving the creditor to the risk of the market.”32 Congress intended that the SARE provisions would protect secured lenders from the unfairness of lengthy delays. Thus, when representing a secured lender, a practitioner’s first step is to ensure that the debtor has checked the box for SARE designation when filing its petition. If the debtor...
has not done so, counsel should move immediately for a court determination that the debtor is a SARE. An early determination is preferable. Otherwise, the debtor may secure an additional 30 days or more before being required to file a plan or commence interest payments.\textsuperscript{35}

A SARE determination motion should request the court to enter an order determining that the debtor is a SARE nunc pro tunc as of the petition date to preserve the 90-day deadline. At the same time, practitioners should note that Bankruptcy Code Section 362(d)(3) allows for an extension of the 90-day period to a later date “as the court may determine for cause by order entered within that 90-day period.”\textsuperscript{36}

If the debtor fails to comply, a secured creditor should quickly file a motion for relief from the stay on as many grounds as possible. A court must terminate the stay if the debtor lacks equity in the property and the property is not necessary for an effective reorganization.\textsuperscript{37} While a SARE designation does not necessitate a finding that the property is necessary for an effective reorganization,\textsuperscript{38} the debtor must demonstrate how it intends to employ the Bankruptcy Code to effectuate a reorganization within a reason-able period of time.\textsuperscript{39} Even if the debtor has filed a plan, the plan must have a “reasonable possibility of being confirmed within a reasonable time.”\textsuperscript{40} As one court recently noted about this process, “Courts usually require more than manifest unsubstantiated hopes for a successful reorganization.”\textsuperscript{41}

The lack of good faith in the filing of the bankruptcy may also constitute cause for relief from the stay.\textsuperscript{42} Courts consider numerous factors in determining whether bad faith exists, including—but not limited to—whether:

- The debtor’s one asset is subject to a foreclosure action.
- The filing is being used to frustrate the efforts of the secured creditor to enforce its rights.
- The debtor’s cash flows are insufficient to meet debt service and other expenses.
- The case is essentially a two-party dispute between the debtor and the secured creditor.
- Confirming a proposed plan appears to be impossible.\textsuperscript{43}

The secured lender also should obtain an appraisal, if necessary, to prove that the property at issue is undersold. If the debtor lacks equity in the property, the value of the property is declining, and the debtor’s plan indicates only an ability to pay interest and not principal, a court may find that a successful reorganization is not a realistic prospect, which constitutes cause for lifting the stay.\textsuperscript{44} A debtor’s neglect and mismanage-ment of the property also support a finding that no reasonable possibility of reorganization exists.\textsuperscript{45}

Secured lenders also can seek to thwart confirmation of a plan without their consent by purchasing or paying the claims of other creditors that are likely to accept the plan. However, this strategy is limited by Bankruptcy Code Section 1126(e), which provides that the court may disallow the vote of any creditor acting in bad faith in either voting or soliciting votes.\textsuperscript{46}

Despite the fast-track deadlines of the SARE provisions, chapter 11 remains an option for real estate borrowers, because it can provide important additional months for the debtor to raise new capital, market and sell the property in bankruptcy to maximize the sale price, or—in rare instances—confirm a plan restructuring the debt. Whether a plan can be confirmed by a SARE debtor is directly correlated to the value of the property—the more valuable it is, the more likely a plan can be confirmed. If a borrower has been honest and a good manager and operator of the property, the bank will be more likely to negotiate even in chapter 11.\textsuperscript{47}

While the ability to raise new capital sig-nificantly increases the likelihood of confirming a consensual plan, nonconsensual plans nevertheless may be confirmed over the secured lender’s objections. But even though the borrower can gain more time through a chapter 11 filing, that time is short. If the debtor cannot make interest payments or file a confirmable plan, it will likely only gain an additional four to six months to avoid foreclosure.\textsuperscript{48}

2. In addition, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) provides that interest payments must be at the nondis-tribution contract rate of interest as opposed to the “current fair mar-ket rate.” 11 U.S.C. §362(d)(3).
3. See In the Matter of Scotia Pac. Co., LLC, 508 F. 3d 214 (5th Cir. 2007).
4. One commentator predicted that removal of the cap would allow mortgage holders to control the chapter 11 process to their benefit by seizing property for potential gain or leaving it in chapter 11 to serve their other purposes—at the expense of property owners, general unsecured creditors, and the public. Kenneth N. Klee, One Size Fits Some: Single Asset Real Estate Bankruptcy Cases, 87 COLUM. L. REV. 1285 (2002). A recent study shows that many SARE (and non-SARE) real estate cases in the past few years have ended with the secured creditor’s obtaining relief from the automatic stay to foreclose. Faced with this prospect, some owners have simply decided to turn over distressed real property to the lender, often through a deed in lieu of foreclosure before bankruptcy. See Robert L. Eisenbach, Who’s SARE Now? Bankruptcy’s Single Asset Real Estate Rules and Their Impact on Commercial Real Estate, In (The Real Business Bankruptcy Blog, available from the archives at http://bankruptcy.cooley.com (Feb. 17, 2010). Klee’s prediction seems to have been correct, with some real property owners choosing not to file for bankruptcy.
6. See In re CBJ Dev., Inc., 251 B.R. 228, 229-30 (Bankr. D. Neb. 2000); In re Larry Goodwin Golf, Inc., 219 B.R. 391, 392-93 (Bankr. M.D. N.C. 1997); In re Majestic Motel Assocs., 131 B.R. 523, 526 (Bankr. D. Me. 1991) (holding that motel revenues are not “rents” derived from the real property itself, but are generated in large part by the labor and incidental services which the hotel business necessarily furnishes to its guests). See also Klee, 191 B.R. at 51; Philmont Dev. Co., 114 B.R. at 89-90; Oceanside Mission Assocs., 192 B.R. at 235-36; CBJ Dev., 202 B.R. at 472 (finding that hotel operations con-
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A business and thus debtor-hotel operator was not a SARE); In re Whispering Pines Estate, Inc., 341 B.R. 134, 136 (Bankr. D. N.H. 2006).
18 In the Matter of Scotia Pac. Co., LLC, 508 F. 3d 214, 221 (5th Cir. 2007). See Kekkos, 181 B.R. at 51; Philmont Dev. Co., 181 B.R. at 223 n.1 (noting that parent is not a SARE debtor because, among other things, rental income is not its “direct source of income….”).
19 Adams & Kirkham, supra note 7, at 10-11.
20 See id.
22 See id.
23 See id.
24 In re Bonner Mall P’ship, 2 F. 3d 899, 902 n.4 (9th Cir. 1993).
26 In re Barakat, 99 F. 3d 1520, 1525 (9th Cir. 1996) (internal quotes and citations omitted); see also Matter of Greystone III Joint Venture, 995 F. 2d 1274, 1279 (5th Cir. 1991).
27 In re LOOP 76, LLC, 442 B.R. 713 (Bankr. D. Ariz. 2010).
28 See also In re Red Mountain Mach. Co., 448 B.R. 1, 13 (Bankr. D. Ariz. 2011); Accord In re Woodbrook Assocs., 19 F. 3d 312, 319 (7th Cir. 1999).
33 Crosscreek Apartments, 213 B.R. at 539.
35 Adams & Kirkham, supra note 7, at 4 (citing In re Kara Homes, Inc., 363 B.R. 399, 407 (Bankr. D. N.J. 2007)).
40 In re NMP Concord II LLC, No. 10-43080, 2010 WL 3488249, at *3 (Bankr. N.D. Cal. Sept. 1, 2010). See also In re San Valley Newspapers Inc., 171 B.R. 71, 75 (9th Cir. B.A.P. 1994); In re Canal Place LP, 921 F. 2d 569 (5th Cir. 1991).
43 In re Moazma SYED, 238 B.R. 133, 141 (Bankr. N.D. Ill. 1999).
46 In re 255 Park Plaza Assocs. Ltd. P’ship, 100 F. 3d 1214, 1219 (6th Cir. 1996) (holding that secured lender’s purchase of claims at face value to vote the claims against the debtor’s plan and in favor of the lender’s own plan was not in bad faith as it was merely protecting its own self-interest).
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- Supports LACBA’s Projects: Domestic Violence, AIDS Legal Services, Immigration Legal Assistance, and Center for Civic Mediation.
- Contributes to grass roots organizations in Los Angeles County that deliver legal services.
- Raised and allocated more than $8 million to legal service organizations.
- Helped more than 100,000 people receive legal services that would otherwise be out of their reach.

If you have any questions, please contact Ivan Price, Foundation Executive Director at (213) 896-6409 or iprice@lacba.org

To learn more about the Foundation and how you can become a supporter, please visit www.lacbf.org

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STARTING ON TUESDAY, JANUARY 10, Trial Advocacy and the Litigation Section will host one in a series of courses offered by LACBA’s Trial Advocacy Project through which attorneys can get trial experience. This six-evening (Tuesday and Thursday nights from 5:30 to 8:30 P.M.) course provides introductory trial advocacy instruction, emphasizing participant mock trial performance and constructive feedback. Those who attend will learn to mark exhibits, lay evidentiary foundation, deliver opening statements, conduct direct and cross-examination, and deliver closing arguments. Course instructors are seasoned prosecutors with local prosecutorial agencies. Successful completion of this course meets the prerequisites for admission to the five-week Traditional TAP course, taught annually in the fall. Written course materials will be distributed via e-mail prior to the first class, so participants need to provide a correct e-mail address at the time of registration. Enrollment is limited to 14 per class. The registration code number is 011526.

The program will take place at the Los Angeles County Bar Association mock courtroom, 1055 West 7th Street, 27th floor, Downtown. Parking is available at 1055 West 7th and nearby parking lots.

$995—LACBA member
$1,195—all others

16.5 CLE hours, including 1 hour in ethics

TAP: Jury Selection Workshop

ON SATURDAY, JANUARY 21, Trial Advocacy and the Litigation Section will host a program offering introductory and advanced instruction on jury selection for civil and criminal cases.

The first part of the program is a lecture with questions and answers, covering, among other things, selecting the “right” jury, exercising peremptory challenges, making and responding to challenges for cause, unconstitutional use of peremptory challenges, a method for processing prospective juror information, judicial and attorney voir dire, and selecting alternate jurors.

The second part is a workshop in which participants practice voir dire, make and respond to challenges for cause, exercise peremptory challenges, and accept the panel. Participants receive constructive feedback on their performance. Written course materials will be distributed via e-mail prior to the first class. Participants will need to provide a correct e-mail address at the time of registration. The program will begin at 1:30 P.M. and take place at the Los Angeles County Bar Association mock courtroom, 1055 West 7th Street, 27th floor, Downtown. Parking is available at 1055 West 7th and nearby parking lots. The registration code number is 011533.

$250—CLE+ member
$350—LACBA member
$500—all others

3.75 CLE hours

Free Arbitration Training

ON THURSDAY, JANUARY 19, LACBA’s Attorney Client Mediation and Arbitration Services will host a program for all prospective and current volunteers who arbitrate attorney-client fee disputes for the mandatory fee arbitration programs through the local county bars in Los Angeles County and the State Bar of California. The course will provide the basic training required to serve on a bar program’s fee arbitration panel. Nonlawyer lay arbitrators, in addition to attorneys, are also encouraged to attend this training session and join the mandatory fee arbitration program. Speakers will address recent developments in fee arbitration and other important topics, such as writing an enforceable award, the statute of limitations, effect of conflicts of interest, arbitrator disclosure requirements, and controlling the proceeding. The program will take place at the Los Angeles County Bar Association mock courtroom, 1055 West 7th Street, 27th floor, Downtown. Parking is available at 1055 West 7th and nearby parking lots. On-site registration will be available at 5 P.M., with the program continuing from 5:30 to 8:45. The registration code number is 011520. There is no charge for this program.

2.75 CLE hours

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.
We the Jury

RECENTLY, I RECEIVED A SUMMONS for Jury Service. Friends expressed condolences as if I had received a draft notice or word that a close relative had died. But they quickly reassured me that there was no chance that the chair of the ACLU Foundation would be chosen to serve on a jury in a criminal case.

Like most of us, I dreaded the prospect of jury duty and how it would disrupt my law practice (and my billable hours). I hoped I would either just call in and not have to report, or I would make it through my first day and be sent home. Instead, I was in the very first group seated in the jury box for voir dire in a felony case involving charges of identity theft and forgery.

The judge’s standard questions brought out that both my wife and I are lawyers. The prosecutor asked which one of us was the better lawyer. To ensure domestic tranquility, I told him that I was “taking the Fifth Amendment.” When I was asked what kind of law I practiced, I explained that among other things I did civil rights and civil liberties law. I was sure that the prosecutor would not leave me on his jury, but I was soon surprised to hear him announce to the judge, “Your honor, we accept the jury as constituted.”

I sat back and realized that I should be serving on the jury. We all should take our turn. If I were on trial, I’d want people like me on the jury. So then I began to see jury service as both my civic duty and one big MCLE course. Indeed, I learned a lot, and I saw much that could be done better.

All told, there were about three and a half days of opening statements, testimony, and closing arguments and one and a half days of deliberations. Unfortunately, I use the word “days” loosely. All the jurors were frustrated by how little time was spent in session. Generally, we were asked to report at 10:45 A.M., testimony began around 11, we adjourned by noon for a 90-minute lunch break, testimony resumed around 2 P.M., there was an afternoon break, and we were excused around 4:15. In those three and a half days, we heard a total of only eight hours of testimony, or less than two and a half hours per day. In my civil trials, I’m used to about five hours of testimony each day.

Judges in criminal court hear motions every morning even while presiding over a trial. But why ask jurors to show up at 10:45 A.M. to hear an hour or less of testimony and then wait until 1:45 or 2:00 P.M. for the trial to resume? How about hearing motions all day on Mondays and holding trials from 9:00 A.M. to 4:45 P.M. Tuesday through Friday? Or, how about telling jurors to report at 1:30 P.M. sharp every weekday and go until 4:45?

As friends predicted, I was chosen foreperson. I made sure that all the jurors got to say their piece, and I spent considerable time reading and rereading the jury instructions out loud. Some instructions were helpful, and others were not. Importantly, the instructions gave little guidance on what was required for the prosecution to prove the defendant guilty “beyond a reasonable doubt.” The instructions defined it as “proof that leaves you with an abiding conviction that the charge is true.”

I’m not sure that asking jurors whether they have an “abiding” conviction helps them understand the burden of proof. “Abiding?” I looked it up: “Continuing, enduring, lasting, ongoing.” But I thought “beyond a reasonable doubt” has less to do with whether one’s conviction was enduring and more to do with a level of proof of such a convincing character that you would be willing to rely and act upon it without hesitation in your own most important affairs.

On the other hand, the instruction on circumstantial evidence was very helpful. Before we could rely on circumstantial evidence to find a defendant guilty, we had to be convinced that “the only reasonable conclusion supported by the circumstantial evidence is that the defendant is guilty.” Given the presumption of evidence, I was impressed that if a juror could “draw two or more reasonable conclusions from the circumstantial evidence, and one of those reasonable conclusions points to innocence and another to guilt, you must accept the one that points to innocence.”

Unfortunately, after serious and conscientious deliberations, our jury deadlocked. On two of the counts, eleven of us voted not guilty, but one juror held out for guilty. Another charge was much closer: seven guilty, five not guilty.

I was disappointed that we were not able to reach a unanimous decision. I felt that we had not done our job. Unfortunately, a hung jury wastes significant time and money; is burdensome to defendants, lawyers, witnesses, victims, and our crowded courts; places tremendous emotional and financial strains on defendants; and contrary to the prohibition on double jeopardy, allows the prosecution the benefit of a “dress rehearsal.” Statistics show that hung juries cause a mistrial in as many as 24,000 felony criminal jury trials in the United States each year.

Nevertheless, the judge was kind and thanked us for our service. The jury has been called “the jewel and the centerpiece” of the American justice system because it represents the people “standing between a possibly oppressive government and the lonely, accused individual.” Despite the mistrial, I enjoyed the experience, and I was proud to have served. I encourage all lawyers and all citizens to do so.

Stephen Rohde practices civil rights and civil liberties law, intellectual property law, and appellate law with the firm of Rohde & Victoroff in Century City.
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