Owning the Code

Los Angeles lawyer Dan Liu analyzes the U.S. Supreme Court’s decision in *Myriad* regarding the patentability of DNA. Page 20
BUSINESS TAX REFORM: EMERGING ISSUES IN THE TAXATION OF U.S. ENTITIES

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Pass-Through Entity Reform: Is a Major Overall Necessary?

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Engraved on the facade of the U.S. Supreme Court building are these four words: Equal Justice Under Law. These words are “perhaps the most inspiring ideal of our society,” wrote Supreme Court Justice Lewis Powell. They express the fundamental view that “justice should be the same, in substance and availability, without regard to economic status.” Powell’s predecessor, Justice Hugo Black, was more blunt: “There can be no equal justice where the kind of trial a man gets depends on the amount of money he has.”

As a society, how have we fared in fulfilling this ideal of equal justice for all, regardless of economic status? On the civil side, one can persuasively argue that there is ample room for improvement. Do the well-heeled, who are able to afford competent counsel, obtain better outcomes in civil litigation than the self-represented poor? Anecdotal evidence, in the form of a recent courtroom experience I was involved with, suggests the answer is yes.

My law firm’s clients—mostly business entities that can afford to pay legal fees by the hour—sometimes find themselves in lease disputes with their landlords and sometimes even end up on the defense side of an unlawful detainer battle. Earlier this year, while a client and I waited our turn for trial, we saw one unrepresented tenant after another being dealt a swift dose of eviction justice. It was obvious that these folks had little idea what was going on procedurally and no clue how to defend themselves. But when our number was called, my client was able to take advantage of a lucky break: buried deep in the lease’s verbiage was a mandatory prelawsuit mediation clause, which—to the landlord’s surprise and disgust—did not exclude eviction cases from its reach. Result: case dismissed. This outcome did not require great but rather merely competent lawyering. But the want of a competent attorney can and usually does spell the difference between winning and losing, between justice and injustice.

One recent survey revealed that fewer than one-third of Californians who needed assistance with civil cases were able to obtain professional legal help. These low- or no-income citizens have fallen into a justice gap. The recession of 2008 exacerbated the problem. The economy slowed and jobs were lost, and these low- or no-income citizens have fallen into a justice gap. The recession of 2008 exacerbated the problem. These low- or no-income citizens have fallen into a justice gap. The recession of 2008 exacerbated the problem. These low- or no-income citizens have fallen into a justice gap. The recession of 2008 exacerbated the problem. These low- or no-income citizens have fallen into a justice gap. The recession of 2008 exacerbated the problem. These low- or no-income citizens have fallen into a justice gap.

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enter the Campaign for Justice and the Justice Gap Fund. In response to painful losses in legal aid funding, the legislature enacted Business and Professions Code Section 6033 to facilitate the distribution of voluntary contributions in order to “generate the greatest level of financial support...from State Bar members.” The goal is to close the justice gap between the legal needs of low-income Californians and the resources available to assist them. The Campaign for Justice supports close to 100 nonprofits in California.

As Sir Winston Churchill said in 1908, “What is the use of living, if it be not to strive...to make this muddled world a better place?” In this time of the year that is traditionally marked by the spirit of giving, please consider joining the Campaign for Justice (www.CAforJustice.org) and making a donation to the Justice Gap Fund. Someone somewhere will be glad you did.

Paul S. Marks is the chair of the Editorial Board of Los Angeles Lawyer magazine and a partner with Neufeld Marks, a boutique law firm located in Little Tokyo. He serves as a commissioner on the California Commission on Access to Justice.
In response to “Mediation Is Not a Contact Sport” by Judge Joe Hilberman (Closing Argument, January 2011): No one is more civil and professional than Judge Hilberman, so we all would do well to take his sage advice on mediations to heart. A caveat to his suggestion that “most mediations should start with the opposing parties in separate rooms” is that, as hard as it may be to believe, there actually are lawyers who try to sabotage mediations since a settlement means their meal ticket will be canceled. The one chance you and your client have to communicate over the head of such a lawyer is in a joint mediation session with everyone present. In that setting, the other client can hear firsthand about aspects of the case that may have been concealed or sugar-coated and learn what you’re actually willing to do to settle the case.

Stephen F. Robbe

Concerning “How to Create and Maintain a Medicare Set-Aside Trust” in the March 2012 issue (Practice Tips, Sean M. Novak)—although the Medicare Set-Aside Trust (MSA) began to evolve in the late 1990s, in practice a trust to hold the Medicare allocation monies has always been a pretty rare bird. According to data released by the Centers for Medicare and Medicaid Services (CMS) for the years 2005-2008—the latest years for which data is available—the vast majority of workers’ compensation set-aside arrangements, the only kind CMS has ever undertaken to review, are self-administered. In other words, the money goes to the disabled worker, who is not a trustee for the benefit of the government or anyone else. In 2008, over 98 percent of MSAs considered by CMS were self-administered. There is no evidence of substantial follow-up compliance efforts by CMS with self-administered MSAs. Thus, for all the effort being given to the creation of MSAs, the Medicare program remains hardly better off.

William Winslow

The article “Weighing the Balance” by Christopher P. Weskierski and Roxana Amini (October 2012) asserts in a section subtitled “Employee Benefits Discrimination?” that the California Supreme Court has held that California’s Fair Employment and Housing Act (FEHA) does not prohibit discrimination in providing employment benefits and that an employee may not, therefore, bring an FEHA claim on the basis that he or she was subjected to discrimination with respect to the benefits of employment received. It cites Esberg v. Union Oil Company for this proposition. The assertion is problematic for several reasons. The case predates amendments to Government Code Sections 12940 and 12941. The amendments completely undercut Esberg (which was an age discrimination case), if they don’t gut it entirely. Second, the Legislature, at Statute 1999, chapter 22, in Section 4, stated (among other things): “It is the intent of Legislature…to construe and clarify the meaning and effect of existing law and to reject the interpretation given to the law in Esberg…” although it cited the Court of Appeal decision, with which the Supreme Court agreed. Lastly, the following appears in Esberg: “Section 12940 prohibits its employment discrimination in the furnishing of benefits…” Esberg, 28 Cal 4th 262, at 269.

David C. Byers

The April 2013 issue of Los Angeles Lawyer presented an article by Abbas Hadjian titled “The Children of Shari’a” about how Islamic nations apply civil and Islamic legal traditions differently in matters of child custody and spousal support. The article gave credence and even reverence to Islamic Shari’a law and read as if this was just an innocent comparative law course. The article said nothing about how Shari’a is a savage and barbaric set of archaic laws that threaten American democratic rule of law. Shari’a law punishes violators of Islamic law with stonings, executions, amputations, whippings and beatings. Shari’a law allows “honour killings,” genital mutilation, preteen marriages, polygamy, and divorce and inheritance rules that undercut the standing of women (i.e. testimony from non-Muslims and even Muslim women is given less weight than that of Muslim men). The list of human rights abuses of Shari’a go on and on. How your excellent magazine could turn such a blind eye to such human rights atrocities and sanitize Shari’a abuses as a legitimate set of laws worth studying is beyond me.

Baruch C. Cohen

As I read “Scouting for Liability” in the July/August 2013 issue by Kevin D. Hughes (about “a landlord’s accountability for the discriminatory policies of a tenant”), I was surprised to find that there was not even a single mention of Title III of the American with Disabilities Act (ADA), which expressly makes a landlord liable on a joint and several basis for any discriminatory conduct directed at a person with disability. See, for example, 42 U.S.C. Section 12182(a): “No individual shall be discriminated against on the basis of disability...by any person who owns, leases (or leases to), or operates a place of public accommodation.” See also 28 C.F.R Section 36.201(b): “Both the landlord who owns the building that houses a place of public accommodation and the tenant who owns or operates the place of public accommodation are public accommodations subject to the requirements of this part.” Because California’s Unruh Act and Disabled Persons Act extend the recovery of damages to ADA violations for which there are not otherwise damages, landlords (and tenants) have a vested interest in knowing what the other is doing, and not doing, to prevent discrimination against the disabled.

While I understand that the thrust of the article was directed at the decisional law that may extend liability to landlords, there can be no dispute that the ADA leaves little room for judicial interpretation in this area. Perhaps it’s time for a Title III refresher or perhaps another article about trends in Title III litigation?

David Raitzman

Correction

In the sidebar “Non-PI Court Consolidation” to the story “Mastering the Calendar” (October 2013, page 17) the California Academy of Mediation Professionals is mistakenly listed as the California Association of Mortgage Professionals. Los Angeles Lawyer regrets the error.
Compelling the Participation of Recalcitrant Witnesses at Deposition

DEPOSITIONS CAN BE time-consuming and expensive, especially when opposing counsel interferes by interposing meritless objections and instructions not to answer. If possible, it is best to resolve these issues on the record. When opposing counsel instructs the witness not to answer a question, ask for the basis of the instruction. If the grounds are something other than that the answer would call for privileged information, the instruction is typically improper. A deponent is obligated to answer a question at deposition “unless it pertains to privileged matters or depositing counsel’s conduct has reached a stage where suspension is warranted.”1 If the answer does not call for privileged information (e.g., attorney-client), meet and confer with opposing counsel on the record about the merits, or lack thereof, of the instruction. Sometimes it may be appropriate to consider calling the judge to intervene in resolving the dispute immediately. If the court’s assistance is required, call when the judge is not likely to be on the bench and ask the clerk if the judge is willing to hear the matter informally. In order to determine whether the court will entertain such a request, ask for the judge’s permission early in the case to call should disputes arise during depositions.

If calling the judge does not appeal to you and if opposing counsel refuses to budge on the instruction not to answer, your recourse is filing a motion to compel. It is important to point out that completing the deposition on other matters does not waive the right at a later time to move for an order compelling the answer or production of information sought.2

If a deponent fails to answer a question, the deposing party may adjourn the deposition and file a motion to compel.3 While the motion to compel must be “made no later than 60 days after the completion of the record of the deposition,”4 seeking an order on an ex parte basis is preferable since the facts of the deposition will still be fresh in your mind and make the partner on your case happy. Indeed, ex parte orders may be obtained to control deposition scheduling.5

As you prepare your moving papers, keep in mind that when a deponent refuses to answer any question he “bears the burden of justifying such refusal on the motion to compel.”6 If the deponent cannot satisfy this burden, the court “shall order that the answer be given...on the resumption of the deposition.”7 Moreover, the motion should indicate that parties have wide latitude to conduct discovery by taking depositions. As with discovery generally, deposition questions may relate to “any matter, not privileged, that is relevant to the subject matter...if the matter either is itself admissible in evidence or appears reasonably calculated to lead to the discovery of admissible evidence.”8 Through unwarranted objections and improper instructions not to answer, opposing counsel and the deponent plainly interfere with legitimate discovery efforts.

A case on point is In re Marriage of Lemen.9 In Lemen, the witness, Goodman, appeared for deposition and was represented by attorney Dorsey. Goodman refused to answer 28 questions at the deposition.10 The deposing party moved to compel answers and sought sanctions against Dorsey and Goodman. The trial court granted relief, finding “Dorsey’s conduct...went beyond his duty to protect Goodman from harassment and that he was a harassing element at the deposition.”11 The appellate court affirmed and determined that “[t]he conduct of Goodman and Dorsey appears part of a calculated course to frustrate the achievement of the legitimate purposes of discovery.”12

If opposing counsel used objections and instructions to stifle discovery, as the attorney in Lemen was found to have done, say this in your brief and request that the court order the deponent to respond to the questions he or she wrongfully refused to answer at the deposition and that deponent appear at the continuation of the deposition.

When filing a motion to compel deposition answers or an ex parte application for an order compelling deposition answers, include with the moving papers a proposed order and a separate statement of deposition questions and responses at issue. Pursuant to California Rule of Court 3.1345, “[a]ny motion involving the content of a response to a deposition question must be accompanied by a separate statement” that includes “[t]he text of the” deposition question, “[t]he text of [the] response,” and a “statement of the factual and legal reasons for compelling further responses.”

The exact question and response must be stated in the separate statement that accompanies the moving papers. Therefore, a copy of the deposition transcript should be available when the motion is being drafted. Accordingly, consider ordering the transcript on an expedited basis so the matter can be presented to the court as soon as possible. If the deponent was instructed not to answer basic, nonprivileged, and plainly relevant questions, and if the trial date is rapidly approaching, spending the extra money to expedite the transcript is a good investment for you and your client.

Although a judge would rather see you and your adversary work out disputes arising at depositions informally, sometimes seeking court intervention is the only viable remedy. Follow these steps to file a strong motion to compel and get the answers you deserve.

3 Id.
9 In re Marriage of Lemen, 113 Cal. App. 3d 769 (1980).
10 Id. at 776.
11 Id. at 776-78, 782.
12 Id. at 782-83.

Robert Glassman is an associate at Panish Shea & Boyle LLP who litigates large and complex personal injury, wrongful death, and product defect cases. He serves as vice president of the Barristers.
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Addressing the Problem of Bogus Liens

LITIGANTS CAN BE ANGRY and irrational. Some may even be self-styled sovereign citizens or members of political fringe groups. These individuals may file or record fraudulent liens to retaliate against the attorneys who represent their opponents. Although these liens may be clearly illegitimate, their expungement requires a court order, costing victims significant time and effort.1 Attorneys should therefore be aware of the practice of false lien filing and what can be done to combat it.2

Under Division 9 of California’s Commercial Code, a secured creditor may file what is known as a UCC-1 to record a lien.3 A UCC, also known as a financing statement, is a form on which a filer files in the name of the debtor, the name of the creditor, a description of the collateral, and a return address. Common descriptions of collateral on a bogus UCC-1 include the address and legal description of a property, “all personal and real property,” and office addresses. Typically, if a UCC-1 contains a properly complete legal description of a property with its parcel number included, the recorder will attach the lien to the property, along with the name of the grantor (the victim attorney) and grantee (the bogus filer). A client, attorney, spouse, law firm, partner, associate, or paralegal may be listed as a lien debtor. The filer becomes the lien creditor. A person can file the lien without the actual “wet” signature of the debtor.

Division 9 does not compel the secretary of state or county recorder to verify that the secured party has the authority to file or record a financing statement. Furthermore, filing agencies are not required to verify that a debtor has authorized the creditor to file the financing statement. The secretary of state’s Web page permits online filings, and the filing fees are low. County recorders maintain indexes of real property transactions, and the records are available to the public, often online. A filer can easily file many UCC-1s without a court order.

The UCC is not the only weapon available to disgruntled litigants. They can also record a Claim of Lien Affidavit or Affidavit of Lien with a county recorder. As provided in the Government Code, the county recorder may mail the lien notices to the lien debtor at the address listed in the affidavit.4 The filer may also mail a lien notice to the home of the victim. For example, in one case, a woman drew up a document titled Affidavit of Information—Felony, High Crimes and Misdemeanors—18 United States Code 4—Federal Criminal Procedure, Rule 3. The document accused her supervisor of domestic mixed war, war, malfeasance of office, slavery, treason, fraud, and robbery. The filer sought $420,000 in damages. The filer sent the document by Federal Express to her supervisor, who received it the next day, which was the supervisor’s birthday. Security guards ushered the filer from the building upon her return to work. Within days, however, the filer mailed copies of the recorded liens to the supervisor’s home. These liens contained the address, title owner, and legal description. The title owner of the home was the supervisor’s 85-year-old mother, who lived with the supervisor. The harassment stopped only when the victim obtained a court order expunging the liens.5

California and federal courts have the power to impose sanctions, including termination of litigation, for outrageous conduct.6 The victim of bogus liens can petition a trial court for an expungement order and injunction under the court’s equitable powers. Given the ease with which liens may be filed, however, a court order may not stop a determined harasser. Fraudulent liens embarrass victims who, for example, attempt to engage in a real estate transaction. The liens can impede, delay, or increase the cost of a credit transaction, the refinancing of a home, or a loan to buy a home. Bogus liens may prompt a title company to hesitate or even refuse to insure title. The delays caused by these liens may lead to the collapse of a transaction, which in turn could cause litigation.

Bogus liens can do more than harass. They may also be used to intimidate witnesses, attorneys, staff members, and employees. Once a lien is filed, the fear of additional liens may dissuade others from participating in litigation. People may refuse to sign their names to any papers, show up in court, or even have their names disclosed in discovery. Even though the liens are fraudulent, people may allow fear of encumbrance on their home, threat of criminal prosecution, or a blot on their reputations to overrule their desire to take part in a case.

Section 9518(c) endangers attorneys by failing to provide for a summary means of expunging bogus UCC filings.

Unfortunately, Division 9 does not offer a summary means of expungement.7 At best, Section 9518(a) of the Commercial Code offers the lien debtor an opportunity to explain the bogus filing but not to expunge the lien. As the court in Gruber v. Tilton8 explained:

There is no procedure for revoking or removing a UCC—1. The form stays filed over its life, typically five years.... A person can file a termination statement stating a lien has been terminated, but the original UCC–1 is still retained on record. A UCC–3 is an amendment document that can be used to continue the lien for an additional five years, to file a termination statement, to file an assignment, or to file a change in collateral. A UCC–5 is a correction statement filed by a person who believes the record is either in error or false.

While the filing or recording of a UCC–3 or UCC–59 may help, these supplemental filings do not expunge the fraudulent UCCs and liens. As illustrated in Gruber, the Commercial Code10 offers a correction...
Remedies

Public officers or employees are entitled to expedited removal proceedings in the state court under the Code of Civil Procedure, which provides for an order to show cause for removal of the lien.14 The court may also order the lien to be recorded.18 It is a crime to file a false or forged instrument is not actionable if the instrument was not legally entitled to affect title to property, and the recording of a lien may be a crime if it is done as an act of witness tampering or intimidation.16

The recording of a fraudulent lien is a crime under California law.17 However, recording a false or forged instrument is not actionable if the instrument was not legally entitled to be recorded.18 It is a crime to file a false document that affects title to property, and the Penal Code protects a property owner if any false or forged document filed with the county recorder affects title to, places an encumbrance on, or places an interest secured by a mortgage or deed of trust on, real property.19 A criminal prosecution, however, may be initiated at the discretion of the district attorney.

Legal scholar Harry Sigman explains the law’s antipathy against screening financing statements: “Filing offices do not have the financial or staff resources, or the competence, to adjudicate disputes between the debtors and secured parties, and such an activity would be a diversion from the primary task for operating an efficient filing system.”20 The lack of resources at the offices of county clerks has resulted in what is called the open drawer policy. However reasonable this policy may be, it allows for abuse. Section 9518(c) endangers attorneys by failing to provide for a summary means of expunging bogus UCC filings or compelling the filing agencies to screen for bogus filings.

Some states are enacting remedies. For example, Pennsylvania now allows for summary expungement.21 Until this or a similar remedy is enacted in California, however, attorneys should be aware that they or their clients may become the target of harassment through the filing of false liens.

1See Com. Code §§9518(c), cmt. 3. (“The filing of a correction statement does not affect the effectiveness of an initial financing statement or other filed record.”) Effective January 1, 2014, §9518(c) will be renamed §9518(e) but will otherwise remain almost identical: “Information statement” will replace “correction statement.”


4Gov’s Code §§27297.5, 27387.

5Documentation on file with author. See also, e.g., http://www.mind-trek.com/practicl/comliens.htm.


10Com. Code §9518(c).


12Id.

13Com. Code §9515(a).


17In addition, federal courts can vacate bogus liens against IRS employees under 26 U.S.C. §7402. Filing a false lien against a federal judge or law enforcement officers is a crime that can punished with a 10-year prison sentence. 18 U.S.C. §1521.

18Penal Code §§115.5, 331.


20Penal Code §§115.5, 331(a).

21See Sigman, supra note 11, at 490.


A SAMPLE BOGUS LIEN

This is sample text from a so-called commercial lien that was recorded with the San Mateo County Recorder:

LIEN CLAIMANT responded to LIEN DEBTOR by a COMMERCIAL AFFIDAVIT and subsequently a NOTICE OF DEFAULT encumbering the position of the LIEN CLAIMANT, proclaiming claims of LIEN DEBTOR to be in error, and demanding point-for-point rebuttal by LIEN DEBTOR and proof of basis for his alleged cause of action against LIEN CLAIMANT within thirty (30) days or abate all action against LIEN CLAIMANTS, in which failure to rebut, LIEN DEBTOR was put on notice that he would be in default.

Such default admits that the LIEN DEBTOR’S claims were false and fraudulent and that LIEN DEBTOR was guilty of criminal violations involved in the action of the LIEN DEBTOR as set forth in the LIEN CLAIMANT’S COMMERCIAL AFFIDAVIT and NOTICE OF DEFAULT and subsequently charged in a CRIMINAL COMPLAINT (AFFIDAVIT OF INFORMATION), given to the Secretary of State California, California Recorder’s Office, and subsequently will Notice the United States Attorney prior to the end of the grace period of 90 days for the LIEN DEBTOR ACTION.

This CLAIM OF LIEN is filed against Mr…, LIEN DEBTOR and spouse, including all Community Property of both, in order to prevent their evasion of financial liability through efforts to shield property and assets by placing said property and assets in their spouse’s names to prevent attachment for satisfaction of suits and liens.

A bogus lien filer may also mail a Notice of Default that provides, for example:

YOU ARE HEREBY NOTICED that you are in default of the opportunity to respond to the COMMERCIAL AFFIDAVITS and Letters sent to you on [date] by federal express mail and hand delivered. You were given the opportunity to rebut the claims made against you but by your failure to answer said AFFIDAVIT(s) an UNREBUTTED AFFIDAVIT BECOMES A JUDGMENT IN COMMERCE. A DEFAULT JUDGMENT is being sought against you having waived the right to answer by acquiescence, tacit admission and failure to contest, rejecting your due process opportunity.

However suspect the language of these fake liens and notices may be, they have served to harass and intimidate attorneys, clients, and public officials.—D.J.C.
IN UNITED STATES V. WINDSOR, the U.S. Supreme Court held that Section 3 of the Defense of Marriage Act (DOMA), which required married same-sex couples to be treated as unmarried for federal law purposes, is a deprivation of equal protection under the Fifth Amendment to the U.S. Constitution.1 With approximately 198 separate Internal Revenue Code (IRC) provisions that refer to marital status,2 the Windsor case was poised to effect major changes in the tax lives of married same-sex couples.3 The case did not, however, hold that all of DOMA is unconstitutional. Windsor challenged only Section 3 of DOMA and did not overturn Section 2, which allows states not to recognize a same-sex marriage performed in another jurisdiction.4 Following Windsor, states may continue to ban same-sex marriage within their jurisdiction and for state law purposes decline to recognize same-sex marriages validly entered into in another jurisdiction. This allows the country be to be divided into “recognition states” and “nonrecognition states.” Since federal tax law historically has looked to the states on the issue of marriage, the existence of recognition and nonrecognition states leaves open the possibility that a same-sex couple validly married in a jurisdiction that allows same-sex marriage but domiciled in a nonrecognition state would not be considered married for federal tax purposes.5 The Internal Revenue Service promised guidance.

On August 29, the Department of Treasury and the IRS issued Revenue Ruling 2013-17 and Notice IRS-2013-72, ruling that same-sex couples legally married in a jurisdiction that recognizes their marriage will be treated as married for all federal tax purposes, including income, gift, and estate taxes, and that such spouses are included for purposes of federal tax law in the terms “spouse,” “husband and wife,” “husband,” and “wife,” and that the term “marriage” includes the marriage of a same-sex couple. This ruling applies regardless whether the couple is domiciled in a recognition or nonrecognition state. Treasury Secretary Jacob J. Lew described the ruling as providing “certainty and clear, coherent tax-filing guidance for all legally married same-sex couples nationwide.”6 While Revenue Ruling 2013-17 resolves many questions about the tax and estate consequences of Windsor, the IRS may provide additional guidance.7

The IRS began applying Revenue Ruling 2013-17 in September, but affected taxpayers who wish to rely on the ruling may do so for earlier periods, as long as the applicable limitations period for filing a claim under IRC Section 6511 has not expired.8 Pursuant to Section 6511, a taxpayer may generally file a claim for refund for three years from the date a return was filed or two years from the date the tax was paid, whichever is later (unless the taxpayer has an agreement with the IRS extending this period); therefore, married same-sex taxpayers may amend tax returns and file refund claims for tax years 2010, 2011, and 2012. If recognition of the same-sex marriage would not benefit the taxpayer for tax purposes, there is no obligation to file an amended return.9 Pursuant to the prospective application of Revenue Ruling 2013-17, the IRS will not review past returns for issues created as a result of recognition of the taxpayer’s marital status.10

Following Windsor and Revenue Ruling 2013-17, California tax attorneys with married same-sex clients have extensive work to accomplish on behalf of these clients. For same-sex clients who reside in California and were legally married in California or another jurisdiction,11 the end of Section 3 of DOMA may have brought a false sense of security and the belief that the only change that they will need to make is changing their income tax filing status to married filing jointly or married filing separately. In fact, the end of Section 3 of DOMA requires a full-scale audit of of their tax planning. Income, gift, and estate tax plans will likely need review, and tax refunds may be applied for, if appropriate. In addition to working with currently married same-sex couples, tax attorneys should be advising any widowed or divorced clients to analyze how the end of their same-sex

Bradford S. Cohen is a partner at Venable LLP in Los Angeles whose practice focuses on business and tax matters for clients in the motion picture, television, music, emerging media, and sports industries. Elizabeth R. Glasgow is an associate at Venable LLP in the Los Angeles and New York offices whose practice focuses on trusts and estates and wealth management, including planning for gay and lesbian couples.
Marriage is affected. Finally, there are same-sex couples who are not married but are considering whether to marry. While the decision to marry is unlikely to be motivated by the couple’s tax plan, tax attorneys should be prepared to discuss how marriage will affect the couple’s tax plan and whether California’s registered domestic partnership is an appropriate alternative.

Married Same-Sex Couples Living in California

Married same-sex couples living in California now have all the benefits and burdens under state and federal tax law that apply to a married heterosexual couple, and tax attorneys should be prepared to provide guidance on how such changes will impact a couple’s income, gift, and estate tax plans.

Attorneys should advise married same-sex couples living in California to assess their current income tax filing status and other elements of their income tax plan. Beginning with the next income tax filing for calendar year 2013, these clients need to determine whether to file as married filing jointly or married filing separately. This change alone will offer more efficient tax preparation for those married same-sex couples that previously were required to file as separate unmarried individuals (and as separate filers, to divide deductions, allocate to different returns children claimed as dependents, and so on) and may now choose to file as married filing jointly. These clients should also update the claimed allowances on their Form W-4, Employee’s Withholding Allowance Certificate, as this may affect future withholdings, and review their quarterly estimated income tax payments if applicable.

For those tax years that remain open (again, 2010, 2011 and 2012, unless an agreement was entered into extending the statute of limitations) married same-sex couples should also determine if they are entitled to an income tax refund based on a lower tax liability than otherwise would have applied if they had been eligible to file as married filing jointly or married filing separately at the time of the filing. Specific income tax items to consider in determining whether the change in filing status may result in a refund include, among others, claiming personal and dependency exemptions, standard or itemized deductions, the earned income tax credit or child tax credit, and exclusion of gain from sale of a principal residence owned by one spouse. Married same-sex couples and their employers also may seek refunds or adjustments of overpayment of FICA taxes and federal income tax withholding (employment taxes) with respect to certain benefits provided to a same-sex spouse of an employee that would otherwise have been excluded from the employee’s gross income and wages if the marriage had been recognized. Such benefits include health coverage benefits or fringe benefits that were provided by the employer to the same-sex spouse and are excludable from income under IRC Sections 106, 117(d), 119, 129 or 132. While this financial analysis should be done to determine if an income tax refund is available, some married same-sex couples may find that the recognition of their marriage increases their income tax liability due to the “marriage penalty.” Married couples who file jointly, and in which each spouse has relatively high earnings, generally owe more tax than they would if each filed as a single unmarried taxpayer because while marginal tax brackets for married joint return filers are higher than for single filers, the brackets are not twice as high. If the marriage penalty would otherwise have applied in past years, then no action need be taken as there is no obligation to amend past income tax returns in this circumstance.

In the same manner that a married same-sex couple’s income tax plan must be updated to reflect the change in the law, so must their gift and estate plans be updated. Prior to Windsor, married same-sex couples were treated as unrelated individuals under the tax laws. As a result, any lifetime gift or bequest under an estate plan to a same-sex spouse was treated as a taxable gift to an unrelated party rather than a gift that qualified for the unlimited marital deduction for gifts and bequests to a spouse. A taxable gift to an unrelated party would reduce the transferor’s applicable unified estate and gift tax exclusion amount (currently $5.25 million, indexed for inflation and scheduled to increase to $5.34 million in 2014, referred to as the “applicable exclusion amount” ), and if the aggregate amount of gifts and/or bequests to the same-sex spouse and others exceeded the applicable exclusion amount, a gift or estate tax would be due. The availability of the unlimited marital deduction now allows married same-sex couples to delay the imposition of these transfer taxes on gifts and bequests between spouses until gifts in excess of the applicable exclusion amount are made to persons other than the spouse or until the death of the surviving spouse.

Many gift and estate plans, however, were drafted without marital deduction planning. With the availability of the unlimited marital deduction, several elements of an existing gift and estate plan should be reviewed. First, the unlimited marital deduction is available to outright gifts or bequests to a spouse and is also available to gifts or bequests made in trust for a spouse as long as terms of the trust will allow the transferred property to be characterized as qualified terminable interest property (QTIP). A QTIP trust (also commonly known as a marital trust) not only offers the unlimited marital tax deduction but also allows the transferor spouse to have control over the disposition of assets at the surviving spouse’s death, since the transferor as the trust creator has the power to determine the remainder beneficiaries of the trust. Without the benefits of the unlimited marital deduction, however, married same-sex couples may have been less inclined to utilize trusts in their estate plan. These clients should revisit their estate plan to determine if a QTIP trust is appropriate for their plan. In addition, if a gift to a same-sex spouse was made outright or in a QTIP trust in a tax year that remains open, an amended gift tax return should be filed to apply for the benefits of the unlimited marital deduction and either restore that portion of the taxpayer’s applicable unified estate and gift tax exclusion amount that was improperly allocated to the gift to the same-sex spouse or QTIP trust and/or to apply for a refund of gift taxes paid.

Since a primary benefit of the unlimited marital deduction in estate tax planning is to delay the imposition of an estate tax, many married same-sex couples may have purchased and maintained life insurance on each spouse’s life as part of their gift and estate plan in order to provide the surviving spouse sufficient liquidity to pay the estate tax due in the absence of the unlimited marital deduction. These individual life insurance policies may no longer satisfy their purpose if the gift and estate plan eliminates any estate tax on the first spouse’s death. If liquidity remains a concern upon the surviving spouse’s death, the couple may wish to modify their gift and estate plan by substituting the individual life insurance policies for a second-to-die life insurance policy, which is often less expensive.

There may also be elements of a gift and estate plan that are not for the benefit of the surviving spouse but are still affected by marital status, including planning with retirement benefits or taking advantage of the ability of spouses to split gifts. For planning with retirement benefits, consider that if there is a qualified retirement plan intended to benefit someone other than the employee’s spouse at the employee’s death, a spousal consent is required. This requirement would not have been imposed on a married same-sex couple before Windsor. In order to ensure that the nonspousal beneficiary designation for a qualified retirement plan is honored, the beneficiary designation with the spousal consent should be reexecuted. Alternatively, married same-sex couples may want to reconsider a beneficiary designation for someone other than the surviving spouse. These couples may now take advantage of qualified retirement plan benefits available for spouses, including rollover distributions, which permit the sur-
viving spouse to roll over her or his qualified retirement plan benefits to her or his own qualified retirement plan or another employer plan, and delays in required minimum distributions from an inherited plan, which permit spouses to defer distributions until the plan participant would have attained the age of 70½ and would have been required to take the required minimum distributions.

Another benefit now available to married same-sex couples is gift splitting, by which a nongifting spouse may consent to treat half of all gifts made by a gifting spouse as made by the nongifting spouse. The availability of gift-splitting mitigates the use of the gifting spouse's applicable exclusion amount. For open tax years, this is another analysis point to determine if amended gift tax returns should be filed.

Due to the breadth of changes that may be appropriate for a married same-sex couples' income, gift, and estate plan, as well as the possibility for tax refunds in open tax years, California tax attorneys should be working with these clients to ensure that they take advantage of the benefits of marital status that are now available.

**Widowed and Divorced Same-Sex Spouses**

Since the tax issue in *Windsor* was a refund for federal estate tax based on the marital deduction for a bequest to a surviving spouse, tax attorneys should clearly be planning to amend any estate tax returns filed for open years that will result in a refund of estate tax. Tax attorneys should also be reviewing estate tax returns for a decedent dying in 2010 and thereafter to maximize the benefits of spousal portability. Portability entitles a surviving spouse to take advantage of the unused portion of a deceased spouse's applicable unified gift and estate tax exemption (DSUE). The DSUE may be used for either lifetime gifts or bequests made by the surviving spouse, and the DSUE augments the surviving spouse's applicable unified gift and estate tax exemption for these gifts and bequests. As the DSUE will only exist for nontaxable estates, tax attorneys should be careful not to focus only on estate tax refund claims of their widowed same-sex clients.

Divorced clients who have ended a same-sex marriage also require advice post-DOMA. Among the federal tax laws based on marital status are those that govern the tax treatment of spousal support payments and transfers of property incident to divorce. Pursuant to *Windsor* and Revenue Ruling 2013-17, the tax treatment of alimony and transfers of property incident to divorce are now also available to same-sex couples under a divorce, separation instrument, or court order.

Spousal support payments that qualify as “alimony” within the meaning of IRC Section 71 are includable as income to the recipient and deductible by the payor. If the divorcing parties do not want the alimony to be taxable to the recipient under IRC Section 71, the terms of their settlement agreement or divorce judgment may permit opting out of this treatment. If the settlement agreement or divorce judgment is silent on the matter, the default rule of taxing the alimony received by the recipient applies. As same-sex couples divorcing pre-*Windsor* and their family law attorneys may not have anticipated that this tax treatment would be available to the divorcing couple, it is likely that many existing settlement agreements or divorce judgments are silent. There are three issues to consider with a same-sex divorced client and his or her alimony obligations or receipts. If the client is the payor, amended income tax return should be filed for all open years claiming the deduction under IRC Section 215. If the client is the recipient, since the IRS is only applying Ruling 2013-17 prospectively and will not be reviewing past returns for issues created as a result of the recognition of the taxpayer’s marital status after *Windsor*, no amended tax returns need be filed. However, beginning with the 2013 tax year the recipient must begin including the alimony as income. If taxing the alimony is not consistent with the former couple's intent, but their settlement agreement or divorce judgment is silent because of their belief that these laws did not apply to them, the former couple must also consider returning to court to modify the agreement or judgment to reflect their intent, if the court retained jurisdiction.

Another benefit now available to divorced same-sex couples is the preferential tax treatment under IRC Section 1041 for transfers of property incident to a divorce. Pursuant to that section, property transferred between spouses because of a divorce is not subject to income or gift tax. If a client’s divorce occurred recently enough that the statute of limitations for the year in which the transfers occurred remains open, amended income tax returns should also be filed to take advantage of IRC Section 1041 and the characterization of these transfers as nontaxable events.

Another issue to consider for same-sex divorced clients involves the distribution of the spouses’ retirement plans in the divorce. Retirement plans are commonly divided in California upon divorce based on a claim of a community property interest in the plan. Generally, if a spouse acquires an interest in an employee’s retirement plan upon divorce, and the retirement plan is not covered by ERISA, it is possible to obtain a qualified domestic relations order that causes the tax on the distribution to be paid by the recipient spouse rather than the employee spouse. If the distribution is made pursuant to a nonqualified domestic relations order—the only order available to married same-sex couples prior to *Windsor*—the employee spouse is liable for the tax on the distribution. As with the alimony and transfers incident to divorce, amended income tax returns for the open tax years should be filed by the employee to take advantage of IRC Section 1041 and the characterization of these transfers as nontaxable events.

**Same-Sex Couples Considering Marriage**

In addition to same-sex marriage, California also allows same-sex couples to register as domestic partners. The U.S. Supreme Court’s ruling in *Hollingsworth v. Perry*, which resulted in the allowance of same-sex marriage in California, did not invalidate or change the existing California laws for registered domestic partners. Accordingly, registered domestic partners in California continue to have the same rights, protections, and benefits, and are subject to the same responsibilities, obligations, and duties under California law as are granted to and imposed upon spouses, including the application of state tax laws in the same manner as a married couple.

In the unlikely event that same-sex clients are seeking advice to choose between marriage or registered domestic partnership solely on the basis of the tax benefits and burdens, attorneys will need to look at the specific financial facts for the couple, specifically their earnings, their current and potential net worth, and the nature of their assets (including ownership of ERISA plans and IRAs). This level of analysis is necessary because while California’s registered domestic partners are treated in the same manner as a married couple for California’s state tax law purposes, the relationship is not recognized as a marriage under federal tax law. Revenue Ruling 2013-17, extending the protections and benefits of the federal tax law to married same-sex couples regardless of their state of residency, expressly does not apply to registered domestic partnerships, civil unions, or other similar formal relationships recognized under state law.

As described above, married same-sex couples in California will have now consistent filing status, exemptions, and other tax attributes on both their state and federal tax returns. In contrast, registered domestic partners in California will essentially have two tax filings. Registered domestic partners are required to file their California state income taxes as married filing jointly or married filing separately but are required to file as unmarried individuals on their federal income tax returns. This results in the additional cost of separately prepared returns for the
state and federal filings. Under such circumstances there are also numerous exclusions and deductions that are available to the domestic registered partners under California but not federal tax law. Examples include 1) an exclusion from gross income for employer-provided accident and health insurance for a registered domestic partner and his or her dependents, 2) an exclusion from gross income for medical expense reimbursement paid by the employer for a registered domestic partner and his or her dependents, if the expense was not previously deducted, 3) an itemized deduction for medical expenses for a registered domestic partner and his or her dependents, 4) a deduction for long-term health insurance expenses paid for a registered domestic partner and his or her dependents, and 5) a deduction for self-employed health insurance expenses incurred for a registered domestic partner and his or her dependents. There may, however, be some federal income tax benefit to registered domestic partnership based on the division of community income. While the IRS does not recognize a registered domestic partnership as a marriage for federal tax law purposes, it does recognize that the relationship creates community property and specifically community income pursuant to California state law. Accordingly, for federal tax purposes, the registered domestic partners must each report half the combined community income earned by the partners on their unmarried individual tax returns. These and other federal income tax considerations for registered domestic partners are comprehensively addressed at the IRS Web site.

The current and potential net worth of the clients is important in assessing the gift and estate tax benefits that may be lost in a registered domestic partnership but are available in a marriage. California does not have an independent gift or estate tax, while the benefits of an unlimited marital deduction for federal gift or estate tax purposes or portability for federal estate tax purposes are only available to a married couple. Similarly, only federal law governs the benefits of an inherited ERISA plan or IRA, which are only available to a married couple.

Although each situation is unique, from a tax perspective marriage is likely to be a better option than registered domestic partnership for same-sex couples in California.

Preparing Records for Refund Claims for Closed Years

One very important tax issue remains open post-Windsor and the IRS rulings. If Section 3 of DOMA is unconstitutional, should taxpayers who paid tax liabilities in excess of the true amount owed because of the then-applied


8 Id.


11 California’s ban on same-sex marriage under Proposition 8 was invalidated following the U.S. Supreme Court’s decision in Hollingsworth v. Perry, 570 U.S. (2013) (Docket No. 12-144). See also Maura Dolan, Prop 8: Gay Marriages Can Resume in California, Court Rules, Los Angeles Times, June 28, 2013, at http://articles.latimes.com/2013/Jun/28/local-la-me-in-prop-8-gay-marriage-20130608. Same-sex marriages are now permitted in California, and California is a recognition state of same-sex marriages performed in other jurisdictions.

12 Married same-sex clients whose 2012 income tax returns were on extension until October 15, 2013, have made this filing status decision for 2012.

13 The IRS is providing special administrative procedures for these purposes and also for services performed by an individual in the employ of the individual’s spouse that are not in the course of the employer’s trade or business or that are domestic services in the employer’s home, which are excepted from FICA tax under IRC Section 3121(b)(3). See I.R.S. Notice 2013-61 (Sept. 23, 2013).


15 I.R.C. §§2056, 2523.

16 I.R.C. §§2056, 2505.

17 I.R.C. §2056.

18 I.R.C. §2010(c)(4).

19 There are certain limitations on the use of DSUE. For example, a surviving spouse may only use the DSUE of his or her last deceased spouse, meaning that if a surviving spouse remarries and the subsequent spouse dies, the surviving spouse loses the DSUE of the first deceased spouse but may use the DSUE (if any) of the second deceased spouse.


21 Fam. Code §297.


23 Fam. Code §297.5(a).


26 The separate filings of the state and federal income tax returns is the same burden that married same-sex couples living in nonrecognition states will face.

27 I.R.C. §§106(a); Rev. & Tax. Code §17021.7.

28 I.R.C. §§103(b); Rev. & Tax. Code §17021.7.

29 I.R.C. §213(a); Rev. & Tax. Code §17021.7.

30 Id.

31 I.R.C. §162(l); Rev. & Tax. Code §17021.7.

32 I.R.S. Publication 555, Community Property.


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by Dan Liu

Owning the Code

The U.S. Supreme Court’s decision in Myriad Genetics distinguishes between DNA and cDNA

CAN SOMEONE, by patenting genes, exclude you from using your own genetic information? This question was at the heart of Association for Molecular Pathology v. Myriad Genetics, Inc. Myriad concerned whether two of the most well-known “cancer genes”—BRCA1 and BRCA2—could be patented. In the parlance of patent lawyers, the case concerned whether the genes were patent-eligible subject matter. People with a faulty BRCA1 or BRCA2 gene face an increased risk of breast and ovarian cancer. In the mid-1990s, the company Myriad Genetics obtained several patents that claim the sequence of the genes. Currently, Myriad sells BRCA gene testing kits. Many people, including Angelina Jolie, have undergone the BRCA gene tests. Others have criticized Myriad for hindering the development of more affordable tests. Many people have no access to Myriad’s tests due to their high cost and the fact that insurance companies do not cover them.

The Myriad case concerned not only the patentability of two genes but also the basic issue of how patent law should be used to promote scientific innovation. Myriad and other biotech firms have long argued that patents are needed to justify the enormous cost of research and development. Without patent protection, this argument goes, investments on research and development of new diagnostic tests would decrease and therefore discourage innovation. Others, including prominent scientists, have contended that patent protection is not necessary to create incentives for biotech innovations. For example, James Watson, the codiscoverer of the double helix structure of DNA and a Nobel laureate, has long argued that patents on human genes are “not necessary to encourage scientists to advance our knowledge and develop innovative new medicines or biotechnology inventions.” One study showed that more than half of all laboratory directors say that they would not develop or would stop developing a new clinical test because of a gene patent. Additionally, “publicly funded research still plays a dominant role

Dan Liu is an associate in Glaser Weil’s Intellectual Property department who focuses primarily on patent litigation.
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in fostering the basic scientific and technological advances that drive biotechnology forward.”13 About two-thirds of patents on gene sequences resulted from federally funded research.14 In the case of Myriad’s patents, the National Institute of Health provided approximately a third of the funding for cloning the BRCA1 gene.15

Aside from policy considerations, the challenge against Myriad’s gene patents is based on the patent statute’s subject matter requirement under 35 USC Section 101, which has not always been a battleground for patent attorneys. More often, litigation has focused on novelty, nonobviousness, or the specification. This perception needs some adjustment, however, after recent decisions regarding Section 101.16 In the last four terms, the U.S. Supreme Court has decided three Section 101 cases: Bilski v. Kappos,17 Mayo Collaborative Services v. Prometheus Laboratories, Inc.,18 and Myriad.19 Myriad’s holding that isolated genes are not patent eligible has reversed a longstanding practice of the U.S. Patent and Trademark Office (PTO).20 The Court did not set forth a clear test for Section 101 determinations nor did it provide much guidance on other issues,21 but its analysis offers guidance for patent lawyers and clients for future cases.

Myriad

The question presented before the Court was whether human genes are patentable. Genes are made up of deoxyribonucleic acid.22 Most DNA molecules are located in a cell’s nucleus in structures called chromosomes. Chromosomal DNA takes the form of double-stranded helices with two chains of nucleotides. The two chains are chemically bound by nucleotide base pairing.23 Some portions of the DNA sequence, known as exons, encode genetic information that is used to make proteins. Portions that do not encode genetic information are known as introns. Within a cell, proteins are made in a two-step process. First, the two strands of the DNA separate, and one strand is copied into a complementary ribonucleic acid (RNA) strand, known as pre-RNA. Pre-RNA is further processed by removing sequences corresponding to introns, resulting in an “exon only” RNA, which is known as messenger RNA (mRNA). Second, mRNA is translated into polypeptides, the sequence of which is determined by the sequence of the mRNA. After that, polypeptides undergo modifications to become mature proteins. Complementary DNA (cDNA) is single-stranded DNA that scientists create artificially by using mRNA as a template. Hence, cDNA is the informational version of the original DNA because it contains only the coding sequence—that is, exons. Using cDNA, scientists can manipulate and study genes and proteins, making cDNA an extremely useful tool for biomedical research.

In 2009, a group of plaintiffs brought a declaratory judgment suit in the Southern District of New York against Myriad, challenging the validity under Section 101 of several of Myriad’s composition and method claims relating to the BRCA1 and BRCA2 genes.24 No method claims reached the Supreme Court. The Federal Circuit, relying on the Supreme Court’s decision in Bilski, found that method claims directed to screening were patentable but method claims directed to comparing or analyzing were not patentable.25

In March 2010, the district court adopted the plaintiffs’ view that DNA is informational and held that the claimed isolated DNA is not patent eligible because it is not “markedly different from native DNA as it exists in nature.”26 Three months later, the Court decided Bilski, affirming that the claimed business method for “protecting against risk” was invalid under Section 101.27 The Court, however, rejected the Federal Circuit’s “machine-or-transformation” test— in which a process is patent-eligible subject matter if “(1) it is tied to a particular machine or apparatus, or (2) it transforms a particular article into a different state or thing”—as the sole test to determine patentability of method claims under Section 101.28 Instead, the Court pointed to its precedents that held that “an abstract idea, law of nature, or mathematical formula” is not patent eligible, but “an application of a law of nature or mathematical formula to a known structure or process may well be deserving of patent protection.”29 The Court found that the business methods at issue claimed “an abstract idea” and thus were not patentable subject matter.30

After Bilski, the Federal Circuit reviewed and reversed the district court’s decision invalidating Myriad’s isolated DNA claims.31 Judge Alan Lourie, writing for the majority, adopted Myriad’s position that DNA is a chemical composition rather than purely informational content.32 Under this view, when DNA is separated from chromosomes by severing the chemical bonds, it becomes a chemical entity distinct from the chromosomal DNA that exists in nature.33 Thus, the court held, isolated DNA, including cDNA, is patent-eligible.34 Judge Kimberly Moore concurred in the judgment but reached the conclusion based on the fact that an isolated DNA sequence “has different properties than the parent molecule from which it is derived.”35 Judge William Bryson, viewing DNA as informational, dissented, arguing that “the isolated genes are not materially different from the native genes” because breaking chemical bonds does not lead to a new molecule, and the isolated genes carry the same genetic information as the native genes.36

In March 2012, the Court vacated the judgment and remanded the case to the Federal Circuit to reconsider in light of Mayo.38 In that case, Prometheus’s patents covered a means for evaluating a drug’s effectiveness that was based on measurements of how the drug was metabolized.39 The Court concluded that Prometheus had not invented the relationship between a drug’s effectiveness and its metabolization rate. Rather, the company had discovered a naturally occurring process and told doctors to apply it.40 The Court unanimously held that this discovery was not patent eligible.41 The Court then considered whether additional limitations would render the claims patent-eligible applications of natural laws. The Court found that the additional steps were “well-understood, routine, conventional activity” and thus insufficient “to transform an unpatentable law of nature into a patent-eligible application of such a law.”42 Under Mayo, a process claim for a newly discovered law of nature is not patent eligible, and this type of claim may become patent-eligible only in combination with an “inventive concept.”43

On remand, the Federal Circuit issued a second opinion in Myriad that mostly followed its first opinion.44 The plaintiffs filed a second petition for a writ of certiorari, and the Supreme Court granted it.45 The only issue before the Court was whether human genes are patentable.46 In June 2013, the Court issued its opinion, holding that naturally occurring DNA is not patent-eligible because it is a product of nature, but cDNA is patent-eligible because it does not occur in nature.47

The Myriad Court began by repeating the principles it set forth in Mayo that Section 101 defines patent eligibility broadly, with one judicially created exception: “[L]aws of nature, natural phenomena, and abstract ideas...are the basic tools for scientific and technological work” and are not patentable.48 Without this exception, the Court reasoned, the use of these basic research tools would “inhibit future innovation premised upon them.”49 The Court also acknowledged that the rule against patenting naturally occurring things “is not without limits.”50 “[A]ll inventions at some level embody, use, reflect, rest upon, or apply laws of nature, natural phenomena, or abstract ideas.”51 Overbroad interpretation of the exception “could eviscerate patent law.”52

Regarding the BRCA1 and BRCA2 gene sequences, the Court found that “Myriad did not create anything” because “[t]he location and order of the nucleotides [of the
BRCA genes] existed in nature before Myriad found them." Thus, Myriad’s gene claims are different from the modified, “nonnaturally occurring” bacterium that the Court had found to be patentable in *Diamond v. Chakrabarty*. The Court also rejected several of Myriad’s arguments. First, discovery, no matter how groundbreaking or brilliant, “does not by itself satisfy the §101 inquiry.” Nor does extensive research effort alone meet the demands of Section 101, which requires the subject matter to be new and non-naturally occurring. Simply discovering something that already exists in nature does not meet this requirement. Second, the Court ruled that isolating DNA from the chromosome does not save Myriad’s claims because they “focus on genetic information encoded in the BRCA1 and BRCA2 genes” rather than the chemical composition. Although the Court acknowledged that isolating DNA by severing chemical bonds does create a chemical composition, the Court also recognized that the key to gene patents is claiming the information that the genes carry. Finally, the Court refused to defer to the longstanding PTO practice of granting gene patents because “Congress has not endorsed the views of the PTO.” The Court also cited the government’s position that isolated DNA was not patentable subject matter and the PTO’s practice was not sufficient to hold otherwise. The Court explained that concerns about reliance interests of patent holders should be addressed to Congress.

Unlike isolated chromosomal DNA, however, cDNA does “not present the same obstacles to patentability as naturally occurring, isolated DNA segments.” As the Court pointed out, cDNA does not normally exist in nature but rather is created in a laboratory. Although the cDNA sequence may be “dictated by nature,” as the petitioners argued, the Court found that with the removal of introns from DNA, cDNA becomes “something new.” Thus, cDNA made from a gene that has introns is patentable.

**Patentability of DNA after Myriad**

The Court expressly stated that its opinion was limited to the patentability of isolated DNA and cDNA. Many practitioners and scholars have criticized the Court for refusing to provide clear guidance as to other issues relevant to biotechnology. Nevertheless, it is helpful to analyze *Myriad*’s rationale in order to assess the patentability of DNA and other biologics.

*Myriad* holds that a DNA sequence may be patent eligible only if the sequence is not naturally occurring. Naturally occurring DNA is not patent-eligible because it is a product of nature, while “cDNA is patent-eligible because it is not naturally occurring.” Several inferences can be drawn from this. First, the cDNA of an intronless gene is not patent-eligible because it is indistinguishable from naturally occurring DNA. Many genes in animals and plants do not have introns. Thus, cDNA sequences of intronless genes are the same as the naturally occurring chromosomal DNA.

Intronless genes, according to the Court, can never be patented regardless of whether they were isolated from the genome or entirely created by researchers. Second, although the Court viewed DNA as information, the fact that the intron-removed cDNA carries the same genetic information as the naturally occurring DNA does not render the cDNA unpatentable. Third, partial DNA sequences, such as primers (strands of DNA used as starting points for DNA synthesis) probably would be analyzed under the same test as the full-length DNA. If a partial DNA does not span at least one intron, it would have an identical sequence as the native DNA and therefore be patent ineligible. Fourth, there is an apparent tension between the Court’s decision in *Mayo* and its decision in *Myriad*. In *Myriad*, the patentability of a DNA sequence depends on whether it exists in nature, not on whether the creation of the DNA molecules involves “inventive concepts” as required in *Mayo*. This apparent tension may be understood by distinguishing the composition claims in *Myriad* from the method claiming sequences of intronless genes. The Court resolved the question without addressing the tension between the two decisions.

**Unresolved Questions**

*Myriad* also does not resolve the question of whether cDNA will always be protected under patent law. For example, some scholars argue that patents claiming cDNA “are probably obvious once we assume knowledge of the naturally occurring gene sequence.” Even if cDNA is patentable subject matter under Section 101, it may be obvious and therefore unpatentable under Section 103, which concerns nonobvious subject matter. The genomes of many species, including humans, have been sequenced and published, and there are many gene prediction programs that identify potential genes within DNA sequences. Thus, once a genome is known, most if not all cDNA sequences can be identified by programs and thus would be obvious to a person having ordinary skill in the art. Furthermore, to avoid infringing claims covering cDNA, a gene testing company can easily analyze a segment of genomic DNA that has at least one intron. For these reasons, cDNA
may not always be protected, even if it can be patent-eligible subject matter.

Myriad’s patent also claimed vectors and heterologously expressed genes. Gene sequences may be artificially integrated (or vectored) into existing DNA or cells, which in turn may produce (or express) new sequences or proteins.83 The Court did not consider these patent claims.84 Like the modified bacterium in Chakrabarty, vectors and heterologously expressed genes are not naturally occurring. In 1948, the Supreme Court found in *Funk Brothers Seed Company v. Kalo Inoculant Company* that combining several known nitrogen-fixing bacteria into a single inoculant did not satisfy the Section 101 subject matter requirement because the patentee “did not alter the bacteria in any way.”85 Creating heterologously expressed genes, however, arguably does alter the gene and the original expressing system. Thus, *Funk Brothers is distinguishable from Myriad.* On the other hand, even though claims on heterologously expressed genes may pass muster under Section 101, they are probably obvious under Section 103. Vectors and altered life forms are now routine, conventional research tools. *Myriad* does not address these broader issues.

Another question left by the *Myriad* decision is, “Do mutants qualify as patentable subject matter?” A mutant is an “*organism in which a mutation has occurred that makes it different from wild-type or from the ‘normal’ extent of variation in the population.*”86 Patents on mutants would allow a party to exclude others from studying the mutants or interpreting genetic testing results that indicate these mutants. Myriad’s patents claimed some naturally occurring BRCA mutants.87 The *Myriad* Court expressly declined to “consider the patentability of DNA in which the order of the naturally occurring nucleotide has been altered.”88 But under the Court’s “naturally occurring” test, mutants should not be patent-eligible because they exist in nature. It is more difficult to determine whether mutants that have been created in the laboratory are patentable. First, it is almost impossible to know whether laboratory-created mutants also exist in nature because mutations occur throughout an organism’s lifetime. Second, even if a mutant does not exist in nature,89 that mutant may be considered “obvious” under Section 103 because the difference between the normal sequence and mutant may be obvious to a person having ordinary skill in the art.

Although the *Myriad* decision forecloses most gene patents,90 the Court did suggest that an “innovative method of manipulating genes” or “new applications of knowledge about the BRCA1 and BRCA2 genes” may be patentable.91 Through this suggestion, the Court offered some hope for patenting innovations in gene research. In fact, the Federal Circuit upheld *Myriad’s* method claims for screening potential cancer therapeutics.92

The patentability analysis of polypeptides or proteins under Section 101, however, may be different from that of the DNA sequences. Proteins are large biological molecules that perform many basic and critical functions in the body.93 Purified proteins share the same amino acid sequence of the naturally occurring protein and therefore are not patent eligible. Proteins synthesized through heterologous expression, however, can differ from their naturally occurring counterparts structurally and functionally.94 Consequently, it is unclear whether synthesized proteins and other biological molecules are patent eligible under *Myriad.*

*Myriad* has significantly limited the patent eligibility of DNA. Genomic DNA is naturally occurring and thus patent ineligible, and cDNA is probably obvious. Furthermore, a patent on cDNA may be circumvented. Under the Court’s “naturally occurring” test, any biomolecule is likely patent-ineligible subject matter if it exists in nature.

### Practical Considerations

With Mayo and *Myriad* in mind, patentees and practitioners should consider reviewing portfolios and filing reissue applications to narrow claims that cover natural phenomena or products of nature. Attorneys and clients should also review and amend pending applications. When preparing for new patent applications, applicants should clearly describe the difference between the claimed subject matter and natural phenomena or products of nature to emphasize creation and avoid discovery. Finally, in addition to claiming compositions, practitioners should consider claiming “innovative” methods of making, using, or detecting the compositions. For example, to patent an invention for detecting a particular gene, one can claim the cDNA of that gene, any partial sequence (if at least some of it is noncoding) that may be used for detection, and methods for amplification or hybridization of the gene.

The *Myriad* decision has not stopped the fight over BRCA gene patents. After the decision, Myriad claimed that it still had 24 patents and 515 claims in the BRCA gene patent estate.95 The Federal Circuit held that a few of Myriad’s method claims were valid, and most have not been challenged. In July, Myriad sued Ambry Genetics, one of the first companies to announce that it would offer BRCA genetic testing that was cheaper than *Myriad’s.* Myriad alleged patent infringement and is seeking a preliminary injunction. Ambry responded that *Myriad’s* patents are invalid under Sections 102, 103, and 112.96 The validity of *Myriad’s* patents covering BRCA genes remains to be determined.

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4. Id. at 4.
8. See, e.g., Association for Molecular Pathology, 702 F. Supp. 2d at 203-04, 206.
10. See, e.g., *Myriad,* 569 U.S. ____, Brief for Respondents at 5.
15. Id.
20. Id. at 1, 16.
22. See *Myriad,* 569 U.S. ____, slip op. at 2-3, and Brief for Petitioners at 1; Association for Molecular Pathology, 702 F. Supp. 2d at 192-211.
24. Among the plaintiffs are several professional associations of research scientists, including the Association for Molecular Pathology, the ACLU, individual researchers, women’s health advocacy groups, and patients with breast or ovarian cancer. *Myriad* moved to dismiss the complaint for lack of standing. The district court ruled against *Myriad.* Association for Molecular Pathology v. U.S.P.T.O., 669 F. Supp. 2d 365, 392 (S.D. N.Y. 2009); The Federal Circuit found that at least one plaintiff has standing to challenge *Myriad’s* patents and thus affirmed the district court’s ruling. Association for Molecular Pathology v. U.S.P.T.O., 689 F. 3d 1303, 1309 (Fed. Cir. 2012). The Supreme Court, in a footnote, affirmed the Federal Circuit and put the standing issue to rest. *Myriad,* 569 U.S. ____, slip op. at 10 n.3.
25. *Myriad,* 569 U.S. ____, slip op. at 20; Association
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69 See, e.g., Noonan, supra note 21; Crouch, supra note 21.
70 Myriad Genetics, 569 U.S. ____, slip op. at 1.
71 Id. at 17.
73 Myriad Genetics, 569 U.S. ____, slip op. at 14-15.
74 The petitioners argued that cDNA and DNA “encode the same polypeptide/protein.” Id., Brief for Petitioners at 49. The Court did not address this argument directly.
76 Jeffrey Lefstin, a respected patent scholar, has pointed out that the Court’s endorsement of cDNA relies on cDNA’s being new within the meaning of §101, not whether creation of cDNA involved anything beyond the “routine and conventional” activity described in Mayo. Crouch, supra note 21.
77 Myriad Genetics, 569 U.S. ____, slip op. at 17. The Court described Myriad’s method as “well understood, widely used, and fairly uniform insofar as any scientist engaged in the search for a gene would likely have utilized a similar approach.” Id. This suggests that the Court would rely on Mayo’s “inventive concept” test to determine the patentability of a method claim.
78 Id., Brief for Petitioners at i.
79 Id., slip op. at 1.
80 Crouch, supra note 21.
81 See, e.g., BRIAN BARRY, BIOINFORMATICS & FUNCTIONAL GENOMICS 525 (2d ed. 2009).
82 E-mail message from Professor Mark Lemley to author (July 30, 2013) (on file with author). This approach, however, may be challenged under the doctrine of equivalents.
84 Myriad Genetics, 569 U.S. ____, slip op. at 1.
88 Myriad Genetics, 569 U.S. ____, slip op. at 18.
89 For example, inosine is a nucleotide that does not occur in genomic DNA or mRNA but can pair with adenine, cytosine, or thymine. Thus, replacing adenine, guanosine, or thymine with inosine would result in artificial DNA that has the same genetic information that was encoded in the original DNA.
90 Myriad forecloses all naturally occurring genomic DNA; cDNA patents are easier to design around and may be rendered obvious once genomic DNA sequence is known.
91 Myriad Genetics, 569 U.S. ____, slip op. at 17.
92 Association for Molecular Pathology, 689 F. 3d 1303 (Fed. Cir. 2012).
94 ALBERTS, supra note 86.
96 Myriad v. Ambry, No. 2:13-cv-00640-RJS (D. Utah 2013), Complaint; Ambry Genetic Corp.’s Answer to Plaintiffs’ Complaint; Affirmative Defenses; and Counterclaims for Antitrust Violations of the Sherman Act and Declaratory Relief of Invalidity and Non-infringement at 29-30. Ambry also asserted antitrust violation and patent misuse defenses. Id. at 32.
The Fitness of RECHARACTERIZATION

Fitness Holdings affirms a nuanced, fact-based analysis of insider financing

THE ENTITLEMENT of creditors’ claims to distribution ahead of holders of equity interests in the debtor is inherent in the Bankruptcy Code.1 “Treating an equity investor on a par with unsecured creditors disregards the principles underlying the absolute priority rule in a manner that undermines this basic bankruptcy concept.”2 Consequently, the similar, and sometimes overlapping, but distinct doctrines of recharacterization and equitable subordination were developed by case law.3 While equitable subordination has been incorporated into the Bankruptcy Code,4 recharacterization continues to be applied solely as a creation of case law.5

Recharacterization and equitable subordination are doctrines “aimed at different conduct and have different remedies (although sometimes based on the same facts).”6 The recharacterization analysis generally involves determining whether a funding instrument labeled as debt is in fact an equity investment. Since the substance of the transaction governs over form, if a debt transaction was actually an equity infusion, the recharacterized claim will be treated as equity.7

In contrast, equitable subordination is based on an assessment of the creditor’s behavior. It is used to remedy inequity or unfairness to the debtor’s other creditors by demoting the subordinated creditor’s right to repayment to the rights of other creditors or equity holders. Accordingly, while some courts have confused the doctrines or have mistakenly found that equitable subordination supplants recharacterization in the context of bankruptcy,8 the doctrines address distinct concerns and require bankruptcy courts to conduct different inquiries.9

In Fitness Holdings International, Inc.,10 the Ninth Circuit Court of Appeals addressed for the first time the question of whether bankruptcy courts have the power to recharacterize debt to equity.11 While it may seem obvious that bankruptcy courts have this power, the Ninth Circuit’s Bankruptcy Appellate Panel in In re Pacific Express, Inc., had earlier held that bankruptcy courts lack such authority because “characterization of claims as equity or debt” is governed and limited by equitable subordination under Bankruptcy Code section 510(c).12 Rejecting

David S. Kupetz, a partner at SulmeyerKupetz, is an expert in restructuring, business reorganization, bankruptcy, and other insolvency matters. SulmeyerKupetz represented Fitness Holdings in its chapter 11 case.
Pacific Express, the Ninth Circuit joined other Courts of Appeals in concluding that the Bankruptcy Code provides bankruptcy courts with the power, distinct and independent from equitable subordination, to recharacterize claims.13

Fitness Holdings

Fitness Holdings International, Inc. (FHI), was a chain retailer of high-end fitness equipment. Hancock Park Capital II, L.P., a vehicle created by a private equity firm, was FHI’s sole shareholder and one of its primary lenders.14 Between 2003 and 2006, FHI borrowed more than $24 million from Hancock Park on an unsecured basis, pursuant to 11 subordinated promissory notes.

In 2004, FHI borrowed $12 million from Pacific Western Bank (PWB) secured by all of FHI’s assets. Hancock Park guaranteed FHI’s obligations to PWB.15 By June 2006, FHI was suffering financial difficulties and sought to refinance its debt. Under a new refinancing arrangement, FHI borrowed $25 million from PWB on a secured basis in June 2007, thus increasing PWB’s loans to FHI by $13 million. PWB’s security interests in FHI’s assets covered the full amount of the new financing. Moreover, under the new financing, $8,886,204 was disbursed to pay off PWB’s original secured loan, and $11,995,500 was disbursed to Hancock Park to pay down its unsecured promissory notes, thereby effectively releasing Hancock Park from its guarantee of FHI’s obligations to PWB.16

In the following months, FHI, as a high-end consumer retailer, suffered serious sales losses as the increasing weakness of the economy and steep declines in the retail sector deepened. PWB demanded and obtained from FHI a new guarantee for the entire $25 million that FHI owed PWB. As FHI continued to struggle, PWB made demand for payment in full under both the new secured financing and the new guarantee based on various non-monetary defaults. At this point, FHI was unable to achieve any further accommodations from PWB.

In October 2008, FHI filed a voluntary petition commencing a chapter 11 bankruptcy case. Subsequently, the unsecured creditors’ committee appointed in FHI’s chapter 11 case brought an adversary proceeding against Hancock Park, principals of Hancock Park who were also officers of FHI, and PWB. In this lawsuit, the committee asserted that payments to Hancock Park from the new secured financing were fraudulent transfers and, as a matter of law, it was barred from recharacterizing such loans as equity investments.”21

Other Federal Courts of Appeals The majority approach adopted by various circuit Courts of Appeals addressing recharacterization in the bankruptcy context has used multifactor tests imported from tax cases. The Third, Fourth, Sixth, and Tenth Circuits have used the bankruptcy court’s power under Bankruptcy Code Section 105 as the basis for the court’s authority to recharacterize debt as equity.22 The Courts of Appeals applying multifactor tests have not deviated significantly.23 The Sixth Circuit laid out an 11-factor test. It considers 1) the names given to the instruments, if any, evidencing the indebtedness, 2) the presence or absence of a fixed maturity date and schedule of payments, 3) the presence or absence of a fixed rate of interest and interest payments, 4) the source of repayments; 5) the adequacy of capitalization, 6) the identity of interest between the creditor and the shareholder, 7) the security, if any, for the advances, 8) the corporation’s ability to fund financing from outside lending institutions, 9) the extent to which the advances were subordinated to the claims of outside creditors, 10) the extent to which the advances were used to acquire capital assets, and 11) the presence or absence of a sinking fund to provide repayments.24

The Ninth Circuit concluded that a bankruptcy court has the power to determine whether a transaction creates a debt or an equity interest for purposes of Section 548, whether a transaction creates a debt if it creates a “right to payment” under state law, and whether, if it did not, the court may recharacterize the debt to equity under applicable state law.

The Ninth Circuit concluded that a bankruptcy court has the power to determine whether a transaction creates a debt or an equity interest for purposes of Section 548, whether a transaction creates a debt if it creates a “right to payment” under state law, and whether, if it did not, the court may recharacterize the debt to equity under applicable state law.
The Ninth Circuit was the first Court of Appeals to hold that bankruptcy courts have the power to recharacterize debt to equity in *In re Fitness Holdings International, Inc.*

The doctrine of recharacterization has its roots in tax cases.

The doctrines of recharacterization and equitable subordination are aimed at the same conduct.

The Ninth Circuit addressed for the first time the question of whether bankruptcy courts have the power to recharacterize debt to equity in *In re Pacific Express* and *In re Fitness Holdings, International, Inc.*

The Ninth Circuit’s bankruptcy appellate panel in *In re Fitness Holdings* held that bankruptcy courts have the power to recharacterize debt to equity.

A basic concept underlying the Bankruptcy Code is that claims of creditors are entitled to distribution ahead of holders of equity interests in the debtor.

The Ninth Circuit’s decision in *Fitness Holdings* rejected the earlier decision of the Ninth Circuit’s bankruptcy appellate panel in *Pacific Express*.

A basic concept underlying the Bankruptcy Code is that claims of creditors are entitled to distribution ahead of holders of equity interests in the debtor.

The doctrine of recharacterization has its roots in tax law.

The Ninth Circuit was the first Court of Appeals to conclude that bankruptcy courts have the power to recharacterize claims.

The Ninth Circuit, in *Fitness Holdings*, found that a transfer that constitutes payment of a debtor’s debt cannot be a constructively fraudulent transfer under Section 548 of the Bankruptcy Code.

In determining whether debt should be recharacterized to equity, the substance of the transaction will govern over the form of the transaction.

The Ninth Circuit used the bankruptcy court’s power under Section 549 of the Bankruptcy Code as the basis for the court’s authority to recharacterize debt as equity.

In *Fitness Holdings*, the Ninth Circuit found that whether there is a right to payment in the context of bankruptcy is determined by applicable nonbankruptcy law.

The basic rule in bankruptcy cases is that state law governs the substance of claims.

The doctrine of recharacterization is explicitly set forth in the Bankruptcy Code.

In *Fitness Holdings*, the Ninth Circuit held that a transaction creates a debt if it involves a right to payment under state law.

The Ninth Circuit, in *Fitness Holdings*, concluded that a bankruptcy court does not have the power to determine whether a transaction creates a debt or an equity interest for purposes of Section 548 of the Bankruptcy Code.

The majority approach adopted by Courts of Appeals addressing recharacterization in the bankruptcy context has used multifactor tests imported from tax cases.

In *Fitness Holdings*, the Ninth Circuit joined other Courts of Appeals in concluding that the Bankruptcy Code does not provide bankruptcy courts with the power, distinct and independent from equitable subordination, to recharacterize claims.

In cases involving tax matters, the Ninth Circuit has held that in attempting to determine the true intended substance of a funding transaction, courts consider the economic realities of the transaction at the time it was made and whether the parties intended the funding to be at the risk of the success of the business (equity) or a definite obligation payable in any event (debt).

In *Fitness Holdings*, the Ninth Circuit rejected the approach to recharacterization taken by the other Courts of Appeal, except for the Fifth Circuit in *In re Lothian Oil*.

**ANSWERS**

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

1. True  
2. False  
3. True  
4. False  
5. True  
6. False  
7. True  
8. False  
9. True  
10. False  
11. True  
12. False  
13. True  
14. False  
15. True  
16. False  
17. True  
18. False  
19. True  
20. False
tax cases involving very different issues than priority disputes in bankruptcy cases and take into account the realities of modern financing.\textsuperscript{27}

The Eleventh Circuit adopted an alternative two-prong test that has been described as “amazingly broad.”\textsuperscript{28} Under this minority approach, shareholder loans may be deemed as capital contributions in circumstances in which the trustee proves either initial undercapitalization or that the loans were made when no other disinterested lender would have extended credit.\textsuperscript{29} In contrast, the Fourth Circuit has held that “a claimant’s insider status and a debtor’s undercapitalization alone will normally be insufficient to support the recharacterization of a claim.”\textsuperscript{30}

In \textit{In re Lothian Oil},\textsuperscript{31} the Fifth Circuit articulated a legal framework in which the actual test to be applied for recharacterization may be very similar to that applied by the majority of Courts of Appeals following the multifactor approach; however, a bankruptcy court must look to the applicable nonbankruptcy law (state law) to determine whether the claims at issue may be recharacterized as equity.\textsuperscript{32} Further, the Fifth Circuit rejected the per se rule applied by the district court limiting application of recharacterization to insiders, stating, “Unless state law makes insider status relevant to characterizing equity versus debt, that status is irrelevant in federal bankruptcy proceedings.”\textsuperscript{33}

\textbf{Ninth Circuit’s Decision in Fitness Holdings}

In \textit{Fitness Holdings}, the Ninth Circuit addressed “whether a debtor’s prebankruptcy transfer of funds to its sole shareholder in repayment of a purported loan may be a constructively fraudulent transfer under 11 U.S.C. \textsection\text{548}(a)(1)(B)).”\textsuperscript{34} The Ninth Circuit found that the issue of recharacterization was squarely before it for the first time in the context of a bankruptcy case, stating, “In order to answer this question, we must determine whether a bankruptcy court has the power to recharacterize the purported loan as an equity investment.”\textsuperscript{35} While \textit{Pacific Express}\textsuperscript{36} had previously found that bankruptcy courts lacked such power and were limited to utilizing the doctrine of equitable subordination as explicitly set forth in section 510(c) of the Bankruptcy Code, a district court in \textit{Daewoo Motor America, Inc.},\textsuperscript{37} declined to follow \textit{Pacific Express}.\textsuperscript{38}

Ninth Circuit cases involving tax matters, however, have a long history of addressing recharacterization of debt to equity, and the court has held that in attempting to determine the intended substance of the transaction, “the court looks to the economic realities of the transaction at the time it was made and to whether the parties intended their advance at that time to be at the risk of the success of the business (equity) or a definite obligation payable in any event (debt).”\textsuperscript{39}

The commencement of FHH’s bankruptcy case created an estate comprising all its assets.\textsuperscript{40} The estate’s representative (the chapter 7 trustee), in order to protect the interests of the estate, may bring an action to avoid a transfer made before the commencement of the case that is allegedly either intentionally fraudulent or constructively fraudulent.\textsuperscript{41} A transfer is constructively fraudulent and can be avoided by the estate’s representative\textsuperscript{42} if the debtor made the transfer on or within two years before the date of the filing of the bankruptcy petition, the debtor “received less than reasonably equivalent value in exchange for such transfer or obligation,” and, in general, the debtor was insolvent or was rendered insolvent by the transfer or obligation.\textsuperscript{43}

In analyzing the requirement for a constructively fraudulent transfer that the debtor “received less than a reasonably equivalent value in exchange for such transfer or obligation,”\textsuperscript{44} the Ninth Circuit examined a series of interlocking statutory definitions.\textsuperscript{45} The phrase “reasonably equivalent value” used in Section 548(a)(1)(B)(i) is not defined in the Bankruptcy Code.\textsuperscript{46} However, “value” is defined and includes the “satisfaction or securing of a present or antecedent debt of the debtor.”\textsuperscript{47} “Under this definition, ‘[p]ayment of a preexisting debt is value, and if the payment is dollar-for-dollar, full value is given.’”\textsuperscript{48} Accordingly, the Ninth Circuit found that “to the extent a transfer constitutes a repayment of the debtor’s antecedent or present debt, the transfer is not constructively fraudulent.”\textsuperscript{49}

The Ninth Circuit next addressed the definition of the term “debt.” The term is defined as “liability on a claim” in the Bankruptcy Code.\textsuperscript{50} The Bankruptcy Code defines “claim,” in relevant part, as “a right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.”\textsuperscript{51} “The Code thus broadly defines ‘debt’ as liability on virtually any type of ‘right to payment.’”\textsuperscript{52}

The Ninth Circuit then turned to the determination of whether there is a “‘right to payment’ that constitutes a ‘claim’ under the [Bankruptcy Code].”\textsuperscript{53} Following U.S. Supreme Court precedent, the Ninth Circuit found that the nature and scope of a right to payment in bankruptcy is determined by applicable nonbankruptcy law, “The Supreme Court has ‘long recognized that the basic federal rule in bankruptcy is that state law governs the substance of claims, Congress having generally left the determination of property rights in the assets of a bankrupt’s estate to state law.’”\textsuperscript{54} The Ninth Circuit found that “subject to any qualifying provision to the Bankruptcy Code...a court must determine whether the asserted interest in the debtor’s assets is a ‘right to payment’ recognized under state law.”\textsuperscript{55}

The Ninth Circuit concluded that a bankruptcy court has the power to determine whether a transaction creates a debt or an equity interest for purposes of Section 548, whether a transaction creates a debt if it creates a “‘right to payment’ under state law, and whether, if it did not, the court may recharacterize the debt to equity under applicable state law.\textsuperscript{56} By rejecting \textit{Pacific Express}, the Ninth Circuit was joining the other Courts of Appeals in concluding that the Bankruptcy Code provides courts with the authority to recharacterize claims in bankruptcy cases.\textsuperscript{57} However, the Ninth Circuit also rejected the recharacterization framework for the inquiry taken by the other Courts of Appeals, except for the Fifth Circuit in \textit{Lothian Oil}.\textsuperscript{58} Accordingly, the Ninth Circuit remanded the question of constructively fraudulent transfer to the district court and explained that viewing the claim through the correct lens “requires the identification of the pertinent legal principles under applicable state law.”\textsuperscript{59}

The question of recharacterization of debt to equity has its roots in tax law and therefore most frequently has been addressed in federal court.\textsuperscript{60} Nonetheless, law has developed in various states recognizing debt recharacterization as a potential defense to the enforceability of insider loans.\textsuperscript{61}

While the Ninth Circuit did not expressly address the question of applicable state law in its published opinion of \textit{Fitness Holdings}, the Hancock Park notes contain governing law provisions providing for the application of California law, and \textit{Fitness Holdings} is a Delaware corporation.\textsuperscript{62} California and Delaware state laws, however, have not yet definitively addressed the question of recharacterization of debt to equity. State courts would likely apply a multifactor test along the lines of those used by the Ninth Circuit in tax cases and the Third, Fourth, Sixth, and Tenth Circuits in bankruptcy matters. The multifactor tests, however, may possibly conflict with general principles of contract interpretation under state law to the extent that they allow external circumstances to override the express intent of the parties set forth in the transaction documents. Furthermore, certain multifactor tests take equitable considerations into account, while others preclude them.\textsuperscript{63} If a claimant’s behavior is taken into account in the recharacterization inquiry and a driving factor in the analysis is fairness and equity, the line between equitable subordination and recharacterization blurs, thereby determining that the applicable form of relief
is equitable subordination and not recharacterization.

Whether an investment is determined to be debt or equity can have significant impact in tax and bankruptcy situations. However, the setting for addressing these issues is very different in bankruptcy from tax matters, which frequently involve solvent companies. The focus of analysis in a tax case is whether a transaction between the investor and the corporation should be deemed to be a debt that would generate a tax benefit to the investor. In contrast, in a bankruptcy case, the issue is frequently whether the claimant/investor who provided a “loan” to a financially distressed enterprise should be treated on par with other creditors or be subordinated. Nonetheless, the law of recharacterization of debt to equity, as applied in bankruptcy cases, has generally been imported from federal tax law.

Ultimately, recharacterization is a question of fact that must be addressed on a case-by-case basis. The question is whether the parties to the transaction intended the “loan” to be a disguised equity contribution. Their intent may be inferred from what is stated in the contract, from what the parties do, and from the economic reality of the circumstances. It is imperative, however, that the economic realities of modern finance and the frequently limited options available to financially distressed businesses are recognized. Much of modern financing can be viewed as falling on a continuum between conventional debt and equity. Moreover, an insider is often the only source of funds for a struggling company. Recharacterization should not be applied in a manner that discourages good faith loans or that defines debt financing in a more limited way than in the real world of modern finance.

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5 In re Equip. Equity Holdings, Inc., 2013 Bankr. LEXIS 1526, at *139.
6 Id.
8 See Unsecured Creditors’ Comm. v. Pioneer Com’t Funding Corp. (In re Pacific Express, Inc.), 69 B.R. 112, 115 (9th Cir. B.A.P. 1986).
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11 In re Daewoo Motor Am., Inc., 471 B.R. at 730.
13 In re Fitness Holdings Int’l, Inc., 2013 U.S. App. LEXIS 8729, at *16-17; Grossman v. Lothian Oil, Inc. (In re Lothian Oil), 650 F. 3d 539, 542-43 (5th Cir. 2011); In re SubMicron Sys., 432 F. 3d 448, 454 (3d Cir. 2006); In re Dornier Aviation, 453 F. 3d 225, 231 (4th Cir. 2006); Sender v. The Bronze Group Ltd. (In re Hedged-Investments Assoc., Inc.), 380 F. 3d 1292, 1298 (10th Cir. 2004); Bayer Corp. v. MascoTech, Inc. (In re Autostyle Plastics, Inc.), 269 F. 3d 726, 748 (6th Cir. 2001).
14 See In re Fitness Holdings Int’l, Inc., 213 U.S. App. LEXIS 8729, at *3. For the facts of the Fitness Holdings case, see the Ninth Circuit’s published opinion and various pleadings filed in the underlying adversary proceeding, bankruptcy case no. 2:08-bk-27527- BR, adversary proceeding no. 2:08-ap-01610-BR, and docket nos. 20, 44, 59, and 72 in the adversary proceeding. The author’s law firm was counsel to the debtor in possession in the chapter 11 case of FHI but did not participate in the adversary proceeding.
16 Id. at *4-5.
17 The committee asserted claims against Hancock Park and PWB for alleged fraudulent transfers based on constructive fraud under Section 548(a)(1)(B) of the Bankruptcy Code and Section 3439.04(a)(2) of the California Civil Code, and for fraudulent transfers based on actual fraud under Section 548(a)(1)(A) of the Bankruptcy Code and Section 3439.04(a)(1) of the California Civil Code.
19 CIV. CODE §3439.04(a).
21 Id. (citing In re Fitness Holdings Int’l, Inc., 2011 U.S. Dist. LEXIS 155104, at *5).
23 See In re Autostyle Plastics, Inc., 269 F. 3d 726, 747-53 (6th Cir. 2001); In re SubMicron Sys. Corp., 432 F. 3d 448, 455 n.8 (3d Cir. 2006); In re Dornier Aviation (N. Am), Inc., 453 F. 3d 225, 233-34 (4th Cir. 2006); In re Hedged-Invs. Assocs., Inc., 380 F. 3d 1292, 1298 (10th Cir. 2004).
24 In re Autostyle Plastics, 269 F. 3d at 749-50.
27 Id. at *147-49 (citation omitted).
28 Id. (citing Estes v. N & D Props., Inc. (In re N&D Props., Inc.), 799 F. 2d 726, 733 (11th Cir. 1986)).
30 In re Dornier Aviation (N. Am), Inc., 453 F. 3d at 225, 234 (4th Cir. 2006).
31 In re Lothian Oil, 650 F. 3d at 539, 543 (5th Cir. 2011).
32 Id.
33 Id. at 544-45.
LEXIS 8729, at *2 (9th Cir. 2013). Remaining claims are addressed in an unpublished memorandum (docket no. 46 in 9th Cir. case no. 11-56677) issued contemporaneously with the published opinion. Id., at *3 n.1. 35 Id. Because the bankruptcy court and the district court dismissed the trustee’s claim for failure to state a claim, the standard of review applied by the 9th Circuit was de novo and the question was whether the plaintiff had failed to allege a plausible claim for relief. Id., at *7.

36 In re Pacific Express, Inc., 69 B.R. 112, 115 (9th Cir. B.A.P. 1986).


38 Id. at 730.


46 In re Fitness Holdings Int’l, Inc., 2013 U.S. App. LEXIS 8729 at *15. While the Trustee brought a “recharacterization” claim as a separate cause of action, the Ninth Circuit interpreted his claim “as a request for a determination that Fitness Holdings’ transfer to Hancock Park was not made in repayment of a ‘debt’ as that term is defined in the Code.” Id., at *8 n.4.

47 Id. at *16.

48 Id. at *17-20 (citations omitted). Lothian Oil involved loan agreements providing that repayment would be in the form of equity interests and royalties and did not provide for interest rates or maturity dates. The court construed the debtor’s request to recharacterize the loans as equity as a request to disallow the lender’s claim under Bankruptcy Code Section 502 on the grounds that the purported loans were “unenforceable against the debtor and property of the debtor, under any agreement or applicable law.” Id. at 543 (quoting 11 U.S.C. §502(b)(1)).

49 In re Fitness Holdings Int’l, Inc., 2013 U.S. App. LEXIS 8729, at *22-23 (9th Cir. 2013).

50 In re Daewoo Motor Am., Inc., 471 B.R. 721, 729 (C.D. Cal. 2012) (citing A.R. Lantz Co. v. United States, 424 F. 2d 1330, 1330-31 (9th Cir. 1970)).


52 See In re Fitness Holdings Int’l, Inc., no. 208-bk-27527-BR, adversary proceeding no. 2:09-ap-01610- BR, docket no. 20. Under the internal affairs doctrine, courts apply the law of the state of incorporation to govern claims that implicate a corporation’s internal affairs. Batchelder v. Kawamoto, 147 F. 3d 915, 929 (9th Cir. 1998).


Cooperatives are enterprises in which individuals or businesses organize to furnish themselves services that the members need. They seek to provide services more efficiently and at lower cost compared to paying third parties or to each member’s performing the service individually. Unlike corporations, in cooperatives ownership and control are equal among members. Cooperatives operate according to the democratic principle of “one member, one vote.” Unlike business corporations, cooperatives do not seek to generate profit but rather seek to save money for their members. Similarly, members do not seek or obtain increased capital value but rather cost savings and efficiency. In contrast to stock in a corporation, membership in a cooperative is not a saleable commodity.

California cooperatives can trace their history to 1844, when a group of cotton mill weavers in England organized, calling themselves the Rochdale Society. They adopted several principles that have been the basis of most cooperatives. These included open membership; one member, one vote; cash-only trading at market prices; patronage refunds proportional to each member’s use of the cooperative’s services; and limited return of interest on contributed capital.

These principles allow for flexibility. The court of appeal has stated that “the presence or absence of one single quality or charac-
teristic should not be viewed as a ‘litmus test’ for determining whether an organization operates mutually or cooperatively.”10 It has been noted that “no one plan of organization is to be labeled as truly co-operative to the exclusion of others.”11 While cooperatives exist to do business with or for their members, “experience has demonstrated...that doing business for nonmembers is usually deemed essential to the success of a cooperative.”12

Cooperatives exist in many endeavors. Growers of fruits and vegetables, dairy farmers, and producers of all kinds form cooperatives. Sunkist, Land O’ Lakes, Sun-Maid, and Blue Diamond are examples of agricultural cooperatives.13 Each is owned by the companies or farmers who use the organization’s services. In rural areas, businesses form cooperatives to generate power and provide themselves water. In California, the Anza Electric Cooperative and the Plumas-Sierra Rural Electric Cooperative are examples. More than 3,000 water utility cooperatives are owned by and provide water to various consumers.14

Financial institutions, often with “mutual” in their names, also may be structured as cooperatives.15 Housing cooperatives provide students a place to live during college. In the retail world, REI is a member-owned cooperative. According to REI, “what began as a group of 23 mountain climbing buddies is now the nation’s largest consumer cooperative.”16 Best Western Hotels, Straw Hat Pizza, ACE Hardware, and True Value Hardware are also cooperatives.17

The tax court has divided cooperatives into two classifications: consumer and producer.18 Consumer cooperatives operate to benefit members as individual consumers. A retail store such as REI, where members purchase goods for their own use, is an example. Producer cooperatives, in turn, benefit members by processing or marketing what they produce. A consumer cooperative may be formed “to engage in any lawful act or activity for which a corporation may be organized.”19 No limitations are stated on the valid purposes of corporations except that they be organized and conduct business primarily for their members’ mutual benefit and not to make a profit.20 This is a broad grant of authority that can include nearly any activity designed to benefit the entity’s members rather than the entity itself.

As the examples above illustrate, dispensing marijuana for medicinal purposes is far from the only reason to form a cooperative. Recent decisions concern cooperatives formed by mushroom farmers “to improve their position in the market for raw fresh mushrooms,”21 school districts to provide themselves insurance,22 school districts to provide themselves bus services for students,23 and boat dealers to obtain “better product pricing by leveraging the group’s buying power.”24 The potential purposes and functions of cooperatives are countless.25 Participating in a cooperative is voluntary, and resignation is possible.26 A member need not be subject to excessive entanglement, although some cooperatives require long-term or other substantive commitments from members and potentially lengthy notice before a resignation takes effect.27

An entity may be a cooperative whether it is incorporated28 or unincorporated.29 California law recognizes unincorporated associations as entities.30 There is no prohibition against a cooperative’s being organized as a limited liability company31 or other structure. There are good reasons to use a corporate form for a cooperative. Corporations are a long-established format for doing business.32 The limited liability company format is newer but also respected as an entity.33

When members conduct their activities jointly, a risk of joint liability arises. One or more participants may fail to meet their financial obligations, or some participants may engage in illegal activity. This makes limiting individual liability an important consideration. In the absence of a corporate entity or LLC status, members face greater risk of being subjected to a claim of personal liability arising from the organization’s endeavors.34 Corporate status reduces this risk.

Corporate or LLC status has the advantage of readily binding members to enforceable obligations. Members are bound to abide by the entity’s bylaws, which are considered to be an agreement among the members.35 A cooperative’s bylaws may contain provisions that can be found in a joint venture or association agreement. Individuals often feel less apprehension at joining an organization than entering a contract. The board of directors and members can have authority to alter the bylaws. Modifications thus occur more easily than in the case of a contract, which may require the approval of all parties.

Status as an entity facilitates clear division of rights and responsibilities among members, patrons, and different classes within these groups. Corporate or LLC status clarifies lines of authority and internal rights among members as well as relations to third persons. Memberships with different rights and restrictions are possible.36 Voting rights of members permitted to vote must be equal,37 but voting may be organized by subgroups within an organization.38

Shares and other forms of membership can have transfer restrictions, preventing holders from conveying their interest to others whose businesses or other attributes are not compatible with the cooperative.39 Under the Consumer Cooperative Corporation law, membership is not transferable unless the cooperative’s articles or bylaws permit it.40 Restrictions may require a holder to stay engaged in a specified activity, remain in a line of business, or meet some other qualification in order to maintain a membership and enjoy rights in the entity.41

The need to comply with state securities laws can sometimes deter forming a corporation or LLC. However, California’s qualification requirements exempt the shares or memberships in a cooperative corporation if the investment does not exceed $300.42 Normally, memberships in a cooperative entity will also be exempt from registration requirements of the federal securities laws.43

Taxes

Cooperatives are not established to generate profit for themselves.44 Still, earnings may result, and the entity may realize net income. Cooperatives are subject to income taxation under subchapter T of the Internal Revenue Code.45 Subject to certain requirements, an entity can deduct patronage dividends and allocations from its taxable income.46 Patronage dividends must be based on the value or quantity of business that the entity does with the patron and the entity’s net earnings from business with all patrons. The cooperative must also have a pre-existing obligation to pay the dividends.47

A cooperative corporation’s taxable income does not include patronage dividends to the extent they are paid in money or certain other forms.48 Other forms include “qualified written notices of allocation” that state the dollar amount credited to the patron’s account.49 At least a fifth of these dividends must be paid in cash, the notice must be redeemable, and the patron must consent to include the noncash allocation.50 These payments qualify for treatment as patronage distributions only if paid within eight-and-one-half months after the close of the taxable year.51 Patronage dividends that are deductible to the entity are taxable to recipients and must be included in their gross income.52 Thus, patronage dividends, including the amounts attributable to qualified notices of allocation and “per unit retain allocations,” must be included in the gross income of patrons in the tax year when these amounts are received.

Cooperative corporations are also subject to California tax law, but they enjoy a deduction for income from business conducted with members.53 The California Revenue and Taxation Code provides that all income of organizations operating on a cooperative or mutual basis that results or arises from business activities for or with members is deductible in computing taxable income.
Similarly, income generated from activities conducted on a nonprofit basis with nonmembers is also deductible.54 These provisions are based on the theory that a cooperative’s earnings are not profits but savings that result for patrons because of their pooled efforts.55 Though normally distributed as patronage dividends, these amount to no more than a downward adjustment in the price of the cooperative’s products or services, or an upward adjustment of prices received for products marketed for patrons.

The Revenue and Taxation Code permits this deduction regardless of whether the income is distributed or accumulated.56 However, other deductions normally allocable to income become nondeductible when allocable to income that is deductible as a patronage dividend.57 This is true regardless of whether the cooperative elects to claim the deduction for patronage dividends.58

**Antitrust Considerations**

The Sherman Act prohibits combinations or agreements that restrain trade.59 The Clayton Act and Robinson-Patman Act prohibit price discrimination.60 The Federal Trade Commission Act prohibits unfair methods of competition and unfair or deceptive acts and practices in or affecting commerce.61 Antitrust laws apply to cooperatives substantially the same way as these laws apply to trade associations.62 Business cooperation does not conflict with preserving competition, and antitrust policy allows leeway for cooperative business activities.

Cooperative industrial research, market surveys, mutual insurance, joint advertising, joint representation before government, and a variety of other joint activities can occur without violating antitrust laws. Federal courts have upheld cooperative advertising programs63 and group purchasing agreements involving cooperatives.64 These activities are valid means to reduce costs.

Congressional policy also acknowledges cooperatives. The Robinson-Patman Act, for example, exempts cooperatives from the Clayton Act’s price discrimination provisions.65 Cooperatives are thus able “to seek through cooperative endeavor the economies and savings of mass operations.”66 They are safeguarded against charges “based on their distribution of earnings or surplus among their members on a patronage basis.”67 Business cooperation also has limits. For example, retail price fixing is illegal.68 It can also be illegal for a cooperative to require members to deal exclusively with the cooperative, whether buying products or services or engaging in distribution.

A line of California decisions concludes that California’s Cartwright Act was “patterned after the Sherman Act and both statutes have their roots in the common law.”69 Courts held that federal decisions interpreting the Sherman Act were applicable to problems arising under the Cartwright Act.70 More recent judicial analysis, however, has determined that the California act was not specifically patterned after the federal antitrust approval of proposed articles, bylaws, and other documents from members, and the organization must approve its incorporation in accordance with its rules and procedures.72

California allows one or more persons to form a cooperative corporation.77 The incorporator need not be a natural person but can be any association, company, corporation, estate, partnership, or government agency.78 The law allows existing unincorporated associations to change their status to become a cooperative corporation upon the organization’s due authorization.79

A cooperative corporation’s articles of incorporation must contain its name, which must 1) not be misleading, 2) include the word “cooperative,” and 3) include some word indicating the entity’s corporate status.80 The articles must also describe its voting rights and rules for determining voting rights if they will be unequal among members.81

Some other provisions are optional but can only have effect if stated in the articles.82 These include provisions limiting the “duration” of the cooperative, or distributing its remaining assets to charity after its debts are paid.83 The code permits the articles to identify initial directors, provide for transfer of membership, allow members to establish an admission price, or make any
provision for managing the entity that is consistent with law.84

The corporation comes into existence when the secretary of state files the articles.85 To operate, however, the organizers must adopt bylaws, elect directors (if not named in the articles), and take actions needed for any corporation to start business. These include appointing officers, opening a bank account, and complying with any local licensing requirements. The incorporators have authority to take some of these actions, and the initial directors normally have authority to complete the rest.86

Provisions setting the number or range of number of directors must be in the bylaws unless stated in the articles of incorporation.87 Alternate directors are allowed, but the bylaws must state the manner and times of their election and the conditions of their service in place of a regular director.88 The code permits any other provision that does not conflict with law or the articles of incorporation, to be included in the bylaws with regard to the management of the entity’s activities and conduct of its affairs.89 Some examples, which are expressly authorized, include provisions on the call, notice, and conduct of directors and committee meetings; elections and voting; director qualifications; director compensation; committees and their composition; compensation, tenure, and duties of officers; reports and financial statements; dues; membership fees; assessments and transfer fees; patronage distributions; eligibility for, status of, and suspension or expulsion from membership; and related matters.90

Directors do not have to be members of the corporation. Sometimes it is useful to include nonmembers on a board, especially nonmembers who have particular knowledge or experience that may benefit the organization. Some organizations divide their boards or set aside some board positions for representatives from geographic areas, or other classifications into which memberships are divided. For example, in a cooperative that performs services for members who grow, produce, or manufacture products, some board positions might be set aside for different categories of members. This assures that interests of members in each relevant group or classification are represented on the board. The cooperative corporation law facilitates this objective by expressly allowing voting based on geographic grouping or other organizational units.91 While proxy and cumulative voting are prohibited,92 the bylaws may provide for delegate voting.93

Organizers may seek to recruit members to capitalize the corporation and participate in its cooperative activities. The articles or bylaws can provide any restrictions on who may become members and delineate required contributions or services from members.94 Organizers or the board of directors may capitalize the corporation by issuing memberships in exchange for no consideration or consideration they deem appropriate.95 In this manner, the organization may obtain initial capital.

Different classes of members may pay different consideration in exchange for different kinds of interests in the entity.96 Voting power may vary, patronage rights may differ, or dividends might be provided for different classes of stock.97 Any differences in rights of classes of members must appear in the articles of incorporation or bylaws.98 Memberships may be issued for a definite period of time to expire at the end of that period.99

The solicitation and issuance of shares or memberships for consideration up to $300 each can be exempt from the qualification requirements of California’s corporate securities law.100 The SEC has frequently indicated that solicitation and issuance of shares or memberships qualify for exemptions from registration under the federal securities laws as well.101 Antifraud law still applies.102

The cooperative corporation may issue shares of stock or membership certificates.103 For purposes of the cooperative corporation law, the terms “share” and “membership certificate” are synonymous and interchangeable.104 However characterized, the instrument serves to evidence a proprietary interest in the corporation. If membership certificates are not used, some receipt or writing memorializing the purchase of a membership must be given to each person who purchases a membership.105

Before issuing a membership, the corporation must disclose in writing to the prospective shareholder or member the following information: 1) that the corporation is a cooperative corporation, 2) whether its articles of incorporation and bylaws will be furnished free on written request and the address where such request should be made, 3) a statement of transfer restrictions, 4) a description of the corporation’s ability to levy dues, assessments, membership or transfer fees, 5) the amount and nature of services that the member must contribute to the corporation, 6) whether the corporation may redeem the membership and whether this may occur at the corporation or member’s option, and 7) a statement describing any inequality in voting power.106

A member is free to resign at any time, although the articles of incorporation or bylaws may require reasonable notice before the resignation takes effect.107 By resigning promptly after an assessment, a member can avoid liability for it; however, resignation does not relieve the member from any liability already incurred.108

A membership may be terminated or suspended by the corporation or a member expelled if this action is done fairly, reasonably, and in good faith.109 The Corporations Code provides nonexclusive safe-harbor procedures for these actions.110 The articles of incorporation or bylaws may also provide that memberships are redeemable, in whole or in part, or on occurrence of certain events or payment of consideration.111

Voting rights are especially significant in a cooperative since it is by vote that members select the directors who make decisions for the entity. While a historic core principle of cooperatives is one member, one vote, the Corporations Code requires that each member have at least one vote112 and that the “voting power of members having voting rights shall be equal.”113 Thus voting rights may be distributed unequally based on patronage or the number of persons affiliated with a member that is itself a cooperative.114

Members or shareholders of cooperative corporations are those who can vote to elect directors or who hold proprietary interests in the corporation.115 Patrons are those who purchase goods or services or whose products or services are handled, processed, or marketed by the cooperative.116 Individuals may have either or both relationships with the corporation.

Typically, members participate in the cooperative in order to be patrons. Hence, the purpose of a cooperative, as stated in the code, is to “conduct its business primarily for the mutual benefit of its members as patrons of the corporation.”117 While members may form and operate the cooperative, it is the patrons who conduct business with and benefit from the entity and who are entitled to receive its distributions, based on the volume or value of business they do with the corporation.118

Individuals or independent businesses that organize as cooperatives can provide themselves with a variety of benefits and services more economically than they could otherwise. While recent cases involving medical marijuana have made cooperatives the subject of court scrutiny, California cooperatives have demonstrated their practicality as alternatives to more traditional corporate structures.119

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84 CORP. CODE §§12200 et seq.
85 HEALTH & SAFETY CODE §§11362.7 et seq.
86 HEALTH & SAFETY CODE §11362.775.


7 See also Puget Sound Plywood, Inc. v. Comm’n, 44 T.C. 305, 306 n.1 (1965); Denton County Elec. Co-op, 368 S.W. 2d at 777; see also CORP. CODE §12201.

8 CORP. CODE §12410(a)(1).


10 Puget Sound Plywood, 44 T.C. at 307.


13 Frost, 278 U.S. at 545 [Brandies, J. dissenting] (quoted in Farmers Co-op. Co., 86 F. Supp. at 208; see also Conway County Farmers Ass’n v. United States, 588 F. 2d 592 (8th Cir. 1979); United States v. Agway, 696 F. 2d 1367 (Fed. Cir. 1982); Corp. Code §12410(a)(1); Denton County Elec. Co-op v. Hackett, 368 S.W. 2d 765, 777 (1962).


15 See, e.g., La Crosse Populaire Ste. Marie v. United States, 563 F. 2d 505, 509 (1st Cir. 1977); see also First City Bank v. National Credit Union Admin., 111 F.3d 433, 435 (6th Cir. 1997).


17 See also http://reic.uwcc.wisc.edu/water.

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Ethics: All You Need to Know
ON SATURDAY, DECEMBER 7, the Professional Responsibility and Ethics Committee will present its ninth annual ethics seminar. Participants will have the opportunity to learn from the top practitioners in the field about the important ethical issues that have a direct impact on the practice of law. The program will take place at the Los Angeles County Bar Association, 1055 West 7th Street, 27th floor, Downtown. Parking is available at 1055 West 7th Street and nearby lots. On-site registration and reception, including breakfast, will begin at 8:30 A.M., with the program continuing from 9:00 A.M. to 1:00 P.M. The registration code number is 012152. The prices below include the meal.
$100—CLE+ member
$140—Small Firm & Sole Practitioner Section member
$180—LACBA member
$240—all others
4 hours CLE credit, including 4 hours of ethics

Antitrust in California
ON TUESDAY, DECEMBER 10, the Antitrust and Unfair Business Practices Section will present its annual Report from Official California. Thomas N. Dahdouh, Kathleen Foote, Thomas A. Papageorge, and Phillip H. Warren will provide a briefing on the priorities and activities of the federal, state, and local government agencies that are actively engaged in antitrust and unfair business practices law enforcement in California. The program will take place at the Los Angeles County Bar Association, 1055 West 7th Street, 27th floor, Downtown. Parking is available at 1055 West 7th Street and nearby lots. On-site registration and lunch will be available at noon, with the program continuing from 12:30 to 2:00 P.M. The registration code number is 012138. The prices below include the meal.
$20—CLE+ member
$40—Antitrust and Litigation Sections members
$50—LACBA member
$60—all others
1.5 CLE hours
Bell v. Feibush Portends Higher Stakes in Fraudulent Lending Cases

IN JANUARY 2013, the Fourth Appellate District of the California Court of Appeal published Bell v. Feibush, which may change the high-stakes litigation game involving disputes between borrowers, and their guarantors, and the lenders and investors who provide the all-important financing.1 Bell applies Penal Code Section 496(c), which provides that any person who has been injured by a violation of Penal Code Section 496(a)—obtaining property in any manner that constitutes theft—may bring an action for three times the amount of actual damages plus the costs of suit, as well as reasonable attorney’s fees. Penal Code Section 496 does not state anywhere that a criminal conviction is a prerequisite for a private plaintiff to recover treble damages.

Section 496(a) makes receiving property that has been obtained in any manner constituting theft a criminal offense punishable by imprisonment. Theft is broadly defined to include, among other things, false pretense, which is the consensual but fraudulent acquisition of property from its owner and causing or procuring others to report falsely as to his or her wealth or mercantile character in order to obtain credit and thereby fraudulently get possession of money or property.

Significantly, the court in Bell held that a criminal conviction is not a prerequisite to recovery of treble damages in a civil action pursuant to Penal Code Section 496(c), noting that the legislature intended to make a criminal conviction a prerequisite to assigning treble damage liability under the statute, it could easily have done so. Indeed, requiring a criminal conviction first would be contrary to public policy because many thefts are simply too small to get the attention of a prosecuting attorney, so the only deterrent is the prospect of a treble damages recovery by the injured victim thereby drying up the market for stolen goods.2

Bell played the role of a lender, investing $202,500 with Feibush, an entrepreneur, based on Feibush’s representation that he owned the Toughlove trademark and needed the money to settle a lawsuit over his interests in the toughlove industry. With the lawsuit out of the way, Feibush told Bell that he would be free to launch a rejuvenated national version of Toughlove that would earn millions. Eventually tiring of Feibush’s promises, Bell asked for her money back and received nothing more than an endless list of excuses.1

Bell filed suit, asserting causes of action against Feibush for breach of contract, fraud, and violation of Penal Code Section 496(a). After a default prove-up hearing, the trial court found that Feibush’s representations were false and that the alleged toughlove business was nothing but a scam. The judgment awarded Bell $202,500 plus prejudgment interest on her breach of contract and fraud claims and treble damages of $607,500 on her Penal Code Section 496(c) claim.3

While some might argue that by awarding Bell treble damages, the court opened the door for creditors to claim that any breach of contract action constitutes fraud, and therefore is a theft under the California Penal Code, Section 484 describes acts constituting theft in rather specific terms, likely precluding any such abuse.

What makes Bell a hot case today is its potential application to several types of high stakes civil disputes including, among others, guarantors and borrowers who misrepresent their financial condition in order to secure loans and unscrupulous entrepreneurs who solicit investments in scam business enterprises.

For example, consider a single-purpose limited liability company formed to build a 300-acre shopping center. Standard commercial lending practice today requires the borrower to put forward one or more high net-worth individuals to personally guarantee the loan. Assume hypothetically that the proposed guarantors (all likely members of the LLC that was specially formed to develop the project) engage in some creative accounting, inflating their assets substantially and, in particular, their liquid assets. If at some point the project fails, the lender will look to the guarantors to make up any loss. When litigation ensues, if the lender can prove that the guarantors inflated their balance sheet, under Bell they may be personally liable for a treble damages award. At a minimum, the prospect of a treble damages award will provide powerful leverage to encourage an early settlement of certain high-stakes cases.

For another example, consider a real estate broker who wants to do more than just sell properties. He identifies an opportunity to develop a condominium complex on vacant land. After minimal preliminary planning, he determines that acquiring the land, permitting, architectural design, construction, and sales will cost $3 million, and he begins to solicit investments. Losing interest, he diverts the funds to other personal needs. When the investors demand that he either start the project or give them their money back, he fraudulently claims that their investments were all spent in the development stage and there is no money to go forward or return. Once again, under Bell the investors may be able to seek a treble damages recovery.

A criminal conviction is not a prerequisite to recovery of treble damages in a civil action pursuant to Penal Code Section 496(c).

Robert Barton is a sole practitioner in Torrance who spent nine years as a large-firm litigation associate. John Spurling is a partner at Shumener, Odson & Oh LLP in Los Angeles.

Notes:
2 Id. at 1046.
3 Id. at 1043.
4 Id. at 1049.
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