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While certainly not a social sheet describing the comings and goings of local lawyers or their personal achievements, Los Angeles Lawyer was also not intended to be an academic law review. Instead, it fills a void among legal publications by having a journalistic mandate and the resources to present articles that meet continuing legal education requirements or provide practical tips. A lawyer can rely on Los Angeles Lawyer and its Web page for research assistance. The lawyer will find articles to answer a client’s inquiry, support a brief, analyze the opposition’s arguments, or help structure a contract. Each article examines the issue at hand and includes references to legal precedents for use in conducting further research.

Los Angeles Lawyer also helps attorneys manage their practices. Last October, for example, an article was published on helping lawyers avoid becoming victims of Internet scams.

The publication is a labor of love by committed professionals; otherwise (apart from being on the cover, which is like being on the cover of Rolling Stone) almost no explanation exists for why a person would voluntarily spend countless hours on researching, writing, and rewriting an article. For Editorial Board members who also author articles, no rational reason can explain such devotion, because Editorial Board members are precluded from being on the cover. Board members spend an equal if not greater amount of their time developing topics, presenting them at monthly board meetings, pursuing and cajoling prospective authors, and editing their drafts.

The sweat and toil expended by authors, board members, the publisher, and staff have not gone unnoticed. Appellate courts periodically cite Los Angeles Lawyer articles in decisions. Equally important, LACBA members acknowledge Los Angeles Lawyer in surveys and elsewhere as a key reason why they joined the association in the first place and remain as members.

Los Angeles Lawyer, however, cannot rest on its laurels. The Editorial Board, publisher, and staff will continue to honor the publication’s mission, but we must also be prepared to stay relevant and accessible in an environment in which lawyers face an informational overload that has reached a point at which they, like others, expect messages to be presented in 140-word tweets. For 2013 and beyond, this will be a difficult but not insurmountable task to meet. Your input is welcome, and if you know a board member or two (the names of the board members appear on the masthead), contact them and express your thoughts.

Our sincere thanks go out to the authors who have given their sweat to these articles and made an invaluable contribution to this special issue. We hope that real estate attorneys and others will find these topics of value in their practices.

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How to Prepare for the Unexpected during Oral Argument

by Shawtina Ferguson

AS MANY LAWYERS CAN ATTEST, oral advocacy is a critical and often dispositive component in litigation. Experienced attorneys and successful advocates teach that oral argument is least effective when approached as an exercise in recitation. Rather, advocates should maintain flexibility and have a sufficient command of the record and applicable law to discern and adapt to the court’s inquiries. What does all this wisdom mean, and how do these idioms translate into tangible best practices to implement during preparation and ultimately when presenting your client’s case before the court?

One of the first steps to undertake when preparing for oral argument is to have a clear command of the applicable law and facts. Advocates should be able to explain, without pause, the relevance of any case cited in his or her papers and, in turn, be able to distinguish the cases cited in the opposing party’s papers. It is also critical to confirm a few days before the hearing that the law cited in the papers is still good law. So, too, should the advocate have a clear understanding of the factual record, not just those facts cited in the papers. The ability to discuss, with reference to the factual record, those issues that the court deems important is vital to the process. “When you are arguing about issue ‘A,’ and the court interrupts and asks about issue ‘B,’ you would be wise to direct your attention to issue ‘B,’ because that is what the court is concerned about,” suggests Patti Jo McKay, the presiding judge of the Appellate Division of the Los Angeles Superior Court. To sharpen your command of the factual record, review valuable sources of information, including but not limited to deposition testimony, discovery responses, affidavits, and other important documents obtained during discovery. Needless to say, on the morning of the hearing, an advocate’s redweld should not contain any document that he or she cannot comfortably summarize or discuss upon reference by an opponent or the court.

Most will agree that practice is a necessary component in the preparation process. However, it is important to practice in an organized and focused manner. After a succinct outline has been prepared, practice making the argument aloud without interruption. This initial exercise is designed to build confidence as well as reveal what areas of the argument need fine tuning. Next, put on the opposing counsel’s figurative hat to determine which areas of the argument are most vulnerable. Consider making a list of the vulnerabilities and listing under each topic two or three reasons why your opponent is mistaken, or, if not mistaken, reasons why that issue has no bearing on the outcome. Practice distinguishing these issues as succinctly but as persuasively as possible. Once you feel comfortable presenting and defending your argument, consider asking a colleague and a nonlawyer to listen to the argument. The feedback they give will likely be divergent, but both points of view will be helpful.

Researching the judge who will hear the argument can also prove valuable. For instance, if the court issues a tentative ruling in advance of the hearing, review it. However, attorneys should understand how to use a tentative ruling during argument. As Judge McKay explains, “Generally, tentatives tell you which way the court is leaning and why. The worst thing an attorney can do is come in and state that they disagree with the tentative; rather, the attorney should spend their time emphasizing additional facts or points of law that the court should consider.” If the tentative is favorable, consider standing quietly and listening to opposing counsel’s argument. If opposing counsel does not present a coherent and persuasive argument, succinctly emphasize those points that support the court’s tentative ruling, and conclude.

Active listening is also key to presenting your best argument. The perceptive ear may find that the court has a misunderstanding of a significant fact or would like guidance. The practice of being an engaged listener during argument will help to discern when corrective or additional information is necessary. Kurt Rasmussen, a California and Missouri trial lawyer who has tried well over 50 cases throughout the country, agrees. “A presentation outline is critical, but if you sense confusion from the court, back up and try it again—going on will not make it better; believe me, I’ve tried and failed and kicked myself afterwards.” Similarly, answer questions posed by the court and then smoothly transition to the strongest points of your argument. This technique will help to foster a conversational tone to your argument that may ease the court’s initial concerns.

Further, always be mindful and adhere to all professional and ethical obligations in all stages of advocacy. Do not misstate the law or facts in your papers or during argument. If the great weight of the case law or the factual record is not favorable, you may lose. Do not risk an ethics violation by misstating or exaggerating the underlying facts or controlling law to reach a favorable outcome. “Be honest with the court, if there is contrary precedent, say so—then say how your case is different,” advises Rasmussen.

Admittedly, every attorney has his or her own eccentric method of preparing and presenting oral argument. While the idiosyncrasies may be particular to the advocate, most will agree that the fundamentals are shared. After argument, if you are confident that the court has a clear understanding of the applicable law and the most important facts governing the case, you have done your job.

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LOCATION, LOCATION, AND LOCATION may be important for a successful real estate investment, but without money, money, and more money, the project will not be built. The current real estate market crisis has severely disrupted traditional capital and financing sources for real estate projects. One nontraditional source of capital, however, is gaining momentum for projects that can demonstrate that they generate new jobs. Under a federal visa program initiated by the U.S. government around the time of a previous recession, foreign investors may make a capital investment in a U.S. business that meets a relatively short list of requirements. In return, the investor can obtain a permanent residence visa (also known as a green card) under the EB-5 program, which is administered by the U.S. Citizenship and Immigration Service (USCIS).

A number of green card rights are very appealing to foreign investors, including the right to 1) enter and exit the U.S. any number of times and without obtaining additional visas (delays from weeks to months in obtaining business visas to enter the United States are becoming common), 2) stay in the United States indefinitely, 3) sponsor the investor’s spouse and unmarried minor children under 21 to obtain permanent status (the investor may relocate his or her family to the United States), 4) work in the U.S. as an employee or owner (other, labor-based visas require the foreigner to have a U.S. employer sponsor the foreigner’s entry, require the employee to have specialized skills, and limit the duration of the foreigner’s stay), 5) qualify for various federal and state benefits, such as social security and in-state tuition rates for higher education, and 6) practice in certain regulated professions (some states limit the ability to obtain professional licenses to citizens or permanent residents).

The EB-5 visa requires the investor to 1) invest $1 million (reduced to $500,000 in high unemployment and rural areas) from lawful sources, 2) in a new business, a substantially restructured business, or in a business in which the foreign investment will result in a material change in the capital of the company, 3) create at least 10 full-time jobs within two years, 4) take on a management role in the business, and 5) operate the business for at least two years. If the application is approved, the investor is issued a provisional green card pending the passage of the two-year period and review of compliance with the requirements for the visa including the job creation requirement. If all is in order, at the end of the two-year period the conditions on the green card are removed. An area of high unemployment, referred to as a Targeted Employment Area, includes a rural area or an urban area that has experienced an unemployment rate of at least 150 percent of the national average rate.

In 1992, a change was made to the EB-5 visa program to add flexibility to how the employment requirements were satisfied. A business may be qualified as a “regional center” if expected to have an employment and business effect in a specified geographic area. If the USCIS accepts a business as a regional center, the investor may be credited for jobs that the business creates indirectly in addition to those that it creates directly. For example, if a multitenant shopping center is designated as a regional center, the full-time jobs created by the ownership and management of the shopping center are directly created jobs. The jobs created by the tenants of the shopping center are indirect jobs. There may be 5 or 10 full-time positions created by operating a property management office, but the jobs created by the tenants of the shopping center could be over 100, and those jobs would all be counted to satisfy the job creation requirement. For these reasons, in a regional center, it is much easier for the investor to meet the employment requirements. Further, if more jobs are counted in the business, more EB-5 investors can participate in the project, resulting in more funding for the developer.

In June 2012, there were approximately 50 approved regional centers designated as regional centers under the EB-5 program.

Satisfying the Requirements of EB-5 Visa Real Estate Investments

BY GORDON K. ENG

Gordon K. Eng is a business transactional lawyer whose practice includes representation of lenders, developers, and investors in real estate and business projects.
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ers in California and approximately 200 in the country. A range of different real estate projects have qualified for regional center status, including shopping malls, hotels, mixed use developments, warehouse distribution centers, manufacturing facilities, and business incubators. Because the key thrust of the regional centers is to create jobs, many regional centers are sponsored by or work extensively with local governments in a form of public-private partnership.

**EB-5 Visa Investment Pitfalls**

A number of recent lawsuits, USCIS administrative actions, and disputes have erupted, pitting the critical parties involved in EB-5 and regional center investments against one another. For example, in 2010, the USCIS terminated the status of the Victorville regional center, which was sponsored by the city of Victorville, for insufficient job creation. This was the first time this action was taken. Victorville had collected about $7.5 million from 15 investors for the construction and operation of a waste treatment plant. The city and its regional center filed suit to prevent termination of its status but withdrew the suit after an administrative appeal of the USCIS termination decision was affirmed. It is reported that the city is refunding some of the investor funds, but, given the termination of the regional center status, it is unlikely that any of the EB-5 investors will obtain their final green cards.

A similar fate was suffered by the El Monte Transit Village project. This regional center was created to develop a 65-acre mixed-use development at the city of El Monte’s bus station. The project has not been completed and is entangled in litigation. The USCIS has determined that the project is “no longer promoting job creation or the kind of local economic development for which it was initially certified to do.” The USCIS terminated the regional center status of the project. To further complicate the situation, two of the principals of the LLC formed to develop the project were arrested by the FBI. The El Monte designated a new developer for the project, and the old developer sued, claiming that it still had the right to proceed.

California is not the only state to experience woes with the EB-5 program. The New Orleans mayor’s office of economic development sponsored a regional center that was operated by NobleReach-NOL, LLC. The private placement issued in connection with the regional center investment claimed that a fund was being formed to invest in a portfolio of business ventures in Louisiana and assist in the reconstruction of New Orleans and the surrounding coastal areas that were devastated by Hurricanes Katrina and Rita. A perusal of the investor suit filed against the general partners of the investment fund shows the diversity of the investors involved in the investor visa program. Partners included citizens from China, Jamaica, New Zealand, Saudi Arabia, Singapore, Turkey, and the United Kingdom. The complaint includes claims of fraud and violation of fiduciary duties, including diversion of funds to pay allegedly exorbitant consulting fees to the general partners. The lesson from these cases is that counsel for investors and developers must be vigilant to abide by the full range of applicable laws and regulations, not just immigration laws.

**Applicability of Securities Laws**

One critical concern is that the investment may be considered a security subject to state and federal securities laws. Developers, promoters, and counsel must be aware of the compliance issues, and investors should be advised of their rights and protections under the applicable securities laws.

In a traditional EB-5 investment, a single investor forms or buys a business, creates the necessary jobs, and actively runs the business. Securities laws may not be applicable in this scenario, but it has become increasingly common for multiple parties to invest in a regional center, and these investors may not exercise much control over the operation of the business. When investors take a passive role, and the developer takes the primary management responsibility for the project, the investment becomes a security, the company becomes an issuer of a security, and the salespersons and other promoters of the investment may also become regulated persons. If the project is subject to securities laws, the developer and counsel must conform with the public offering requirements or an applicable exemption. Larger foreign investor projects will be more suited to compliance with one of the private placement exemptions under SEC Regulation D or Regulation S, so that the cost of compliance can be spread across a larger pool of investors and capital.

Foreign investors in securities should be aware that the U.S. Supreme Court recently reduced the ability of foreign investors to exercise the antifraud provisions of the Securities Exchange Act of 1934 Section 10(b) and SEC Rule 10b-5. In Morrison v. National Australia Bank Ltd., concerning the sale of securities on a foreign stock exchange, the court rejected the prior conduct and effects test that would have allowed for the foreign investors’ claims to proceed. The court held that Section 10(b) and SEC Rule 10b-5 do not have extraterritorial effect, and the antifraud protections only come into play for private actions involving a purchase or sale of securities in the United States. For investor visa transactions, Morrison may limit investor rights if the sale of the capital interests occurs overseas. However, it appears that as a practical matter, while investor visa transactions are marketed overseas, the transactions are typically closed in the United States, because most developers and the USCIS require evidence of the investment funds. One way to provide the evidence is to establish an escrow account in the United States. When the visa application is approved, the funds are released from escrow, and the investment is made in the domestic company. The purchase of the interest is then realized in the United States.

Even if the investor visa transaction were closed overseas, the SEC and state regulators may have antifraud enforcement rights. During oral argument for Morrison, the solicitor general noted that the issue of whether the SEC or state securities regulators could pursue antifraud claims if the fraud had an effect in the United States was not being litigated, so that issue remains unresolved.

**EB-5 Due Diligence**

Another area of concern for investors and developers are the respective rights of the parties under the operative organizational documents. It is an urban myth that investors in visa projects are more concerned with obtaining their green cards than with a return on their investment. While the value that an investor places on obtaining a green card may be part of the analysis, the litigation that has arisen regarding failed regional centers indicates that the goals of investors vary.

In any case, no investor seeks to invest in a project in which he or she will lose both the investment and the green card. Investors should therefore review the organizational documents for a proposed investment to confirm that critical concerns are addressed. For most investors concerns will include whether 1) the project is designed to satisfy such EB-5 visa requirements as creating sufficient employment, 2) the investment is protected from loss to the extent possible under applicable laws and developer willingness, 3) an adequate return on the investment may be realized, and 4) the exit strategy satisfies the investor’s needs. The terms and conditions that the investor should examine in the organizational documents include investor voting rights or approvals on material decisions of the company; provisions that impose fiduciary obligations on the managers; provisions that require the investor’s funds to be used for job creation; rights to remove and replace the managers for mismanagement or other conditions; liquidation preferences; rights to require dividends, distributions, or preferred returns; rights to receive reports and accounting information; disclosures of all fees and
expenses to be charged to the business and the investors; requirements that restrict or require the company to generate the required jobs in the targeted market; rights to inspect the project and its books and records; rights to withdraw from the company; buy-sell rights; and clear and efficient dispute resolution procedures.

Some of the rights and protections that an investor may desire must be tempered by the requirements for the investor visa. For example, an investor cannot be guaranteed a return of invested capital. The USCIS holds that if the investment is not at risk, it does not satisfy the visa requirements. While an investor may reserve the right to withdraw, the investor who does so also withdraws from the visa application process. This could mean waiting another two years and investing in a different regional center, because for each visa application, a business plan must be prepared. The developer and investor should therefore agree on all the specifics in the business plan.

Developers often use go-betweens to market investor visa opportunities, especially for regional centers. Investors should confirm that the statements of the promoters are shared by the developer. A number of reports have arisen of go-betweens overselling the investment, including by stating that the return of the invested funds was guaranteed. Some have reportedly asserted that because the visa is issued by the U.S. government, the program is guaranteed by the U.S. government. Developers also have an interest in assuring that salespersons are not misleading investors. State actions for fraud, breaches of fiduciary duties, and unfair business practices may otherwise ensue.

**EB-5 Visa Responsibilities**

The issuance of a green card includes a number of valuable rights but also includes significant responsibilities that the investors should be prepared to accept. One obligation that investors often miss is that as a green card holder, the investor is subject to federal income and estate taxes, regardless of the amount of time he or she spends in the United States. State income taxes may also apply. Some investors are surprised to learn that the United States taxes its taxpayers based on their worldwide income. The degree of disclosure required for filing U.S. tax returns is daunting for some investors. However, compliance is critical, as the failure to file tax returns and pay income taxes can be a basis to revoke a green card.

As with any business investment, the investor should carefully study the viability of the business. The requisite number of jobs to be created by the enterprise must, in general, survive for two years after the issuance of a green card.
of the provisional green card. Given the current economy, one should expect the survival rate of the current regional centers to be no higher than any other new business. In particular, one should expect that many of the regional centers that were started and approved prior to the economic downturn may have a lower survival rate than newly formed businesses. Investors should engage in the same due diligence they would use for any other investment, including checking the backgrounds, experience, and track records of the managers and any related parties; confirming the ownership, condition, and status of any critical assets of the business; verifying the issuance of critical licenses and permits; and testing the financial assumptions contained in the business plan and budgets.

An EB-5 investor should understand that while a visa may be a valuable addition to the investment, satisfying the immigration requirements should not be the end of the analysis. The business must succeed in order to keep the benefits of the provisional green card, so the investor should approach the investment as he or she would any other investment in a foreign county with people with whom the investor may not have previously done business. Developers should also understand that the applicable laws that must be satisfied go well beyond the immigration laws.

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2 Officially known as a Permanent Resident Card or Form I-551, the green card is no longer green but pink.
4 See www.uscis.gov/eb-5centers.
6 A “rural area” means any area that is both outside of a metropolitan statistical area (MSA) and outside of a city or town having a population of 20,000 or more based on the most recent decennial census. See 8 C.F.R. §204.6(j)(6)(i).
7 Officially known as a Permanent Resident Card or Green Card.
8 See www.uscis.gov/eb-5centers.
12 USCIS regulations provide that the investors cannot transfer their investment to another project. Instead, they are required to reapply for a new EB-5 visa and invest in a new project. See, e.g., Decision of USCIS Administrative Appeals Office, file RCW 1031910138 (July 23, 2012) (on file with author).
13 See Notice of Final Termination, re Victorville Regional Center, from Rosemary Langley Melville, director, California Service Center, USCIS, to Keith C. Melzer (Oct. 20, 2010) (on file with author); see also Rebecca Kimitch, Federal officials shut down foreign investment program in El Monte, PASADENA STAR-NEWS (Oct. 5, 2011).
16 Id. at 1-2.
17 See 8 C.F.R. §204.6(j)(5)(iii) (setting the standard for management participation).
20 See 17 C.F.R. §§230.901-230.905 (exemptions for securities that are sold outside the United States).
22 Id. at 2883-84. The USCIS does not make the information filed for EB-5 applications publicly available, but documentation becomes available when litigation is filed or when administrative guidance is issued.
23 See 8 C.F.R. §204.6(j)(5); USCIS Adjudicator’s Field Manual §22.4, Employment Creation Entrepreneur Cases.
24 See FTB PUBLICATION 1031, GUIDELINES FOR DETERMINING RESIDENT STATUS—2011, California taxes residents based on worldwide income and nonresidents based on California-connected income.
25 See IRS PUBLICATION 519, U.S. TAX GUIDE FOR ALIENS (tax responsibilities of immigrants).
26 8 C.F.R. §316.5(c)(2).
Tax Planning for Foreign Investment in California Real Estate

THE RECENT CONFLUENCE of falling U.S. real estate prices and a weaker dollar, together with the flight of capital from Russia and China, has produced a significant demand for real estate in California, Florida, and Manhattan among foreign investors. This demand is fueled by the global perception that the United States is politically and economically stable (or at least more stable than the alternatives), has a transparent legal system that makes it easy for foreigners to invest in real estate, and imposes no currency controls, making it easy to divest.

A foreigner desiring to invest in U.S. real estate typically has many goals. First, the foreigner may seek privacy. For example, a member of the Vietnamese Politburo who may be concerned about political exposure, a South African who may have violated local currency controls may seek to hide his or her identity, and a Mexican national who may be concerned for his or her physical safety were his or her wealth to become known may all feel a need to keep their real estate investments secret. Second, to the same extent as U.S. nationals, foreigners usually desire to shield their U.S. holdings from creditor claims. Third, unlike U.S. investors who invest in U.S. properties, foreign investors need to minimize their worldwide tax liability. Additional important considerations include whether the real estate is income-producing, and if so, whether the income is passive income or income from a trade or business. Another concern, especially for older investors, is whether the investor is a U.S. resident for estate tax purposes.

Privacy and Liability

Most foreign investors are concerned about privacy. To safeguard it, the real estate should be acquired either by a trust or a legal entity, preferably an LLC. LLCs are generally preferred over corporations because they offer greater structuring flexibility and better creditor protection than corporations, and, unlike a limited partnership, LLCs do not require the formation of a second entity that will act as the general partner. If using a trust, the name of the trustee and the name of the trust must appear on the recorded deed. The investor should not be the trustee, and the trust should not include the investor’s name.

A generic name should be used for an entity. However, if the entity will own California real estate, it will have to register with the California secretary of state, unless the real estate is vacant land or personal use property. Either the initial articles of incorporation or the statement of information will reveal to the world the identity of the corporate officers or the LLC manager. A possible alternative is to use a two-tier structure—a California LLC to own the real estate, and a Delaware LLC to act as the manager of the California LLC. In Delaware, the name of the LLC manager is not required to be disclosed, and all that will appear on California form is the name of the Delaware LLC as the manager. Care should be exercised so that the Delaware LLC is not deemed to be doing business in California, otherwise it will also have to register.

If the real estate is encumbered by debt, the borrower’s name will appear on the recorded deed of trust, even if title is taken in the name of a trust or an LLC. The borrower’s name may be kept private by having the trust entity act as the borrower, with the investor personally guaranteeing the loan. This ensures that the investor’s name does not appear on any recorded documents.

Corporations, limited partnerships, and LLCs will afford owners a shield for any liability arising from the assets or the business of the entity. However, limited partnerships and LLCs are not required to maintain certain corporate formalities (like holding annual meetings of shareholders and maintaining annual minutes), affording creditors fewer bases for piercing the corporate veil. Interests in limited partnerships and LLCs are not attachable by creditors, making them a more effective asset protection vehicle than corporations. Thus, for example, when a creditor obtains a judgment against an individual who owns an apartment building through a corporation, the creditor can force the debtor to turn over the stock of the corporation, resulting in the loss of corporate assets. If the debtor owns the apartment building through an LLC or a limited partnership, the creditor’s remedy is limited to a charging order, which places a lien on distributions from the LLC or limited partnership.

Income Taxation of Real Estate

A person colloquially referred to as a foreigner is known as a non-resident alien (NRA) for federal income tax purposes. An NRA is defined as either a foreign corporation or a person who is 1) physically present in the United States for less than 183 days in any given year, 2) less than 31 days in the current year, 3) physically present for less than 183 total days for a three-year period (using a weighing formula), or 4) does not hold a green card.

Income tax rules applicable to NRAs can be quite complex. As a general rule, an NRA pays a flat 30 percent tax on U.S.-source “fixed or determinable, annual or periodical” (FDAP) income that is not effectively connected to a U.S. trade or business and that is subject to withholding. The rate of tax may be reduced by an applicable treaty. The income is taxed on a gross basis, with almost no offsetting deductions. FDAP includes interest, dividends, royalties, and rents. For example, NRAs that receive interest income from U.S. sources are subject to a 30 percent tax. Other miscellaneous categories of income included within FDAP are certain insurance premiums, annuity payments, gambling winnings, and alimony. NRAs, however, are generally not taxable on their capital gains from U.S. sources unless 1) the NRA is present in the United States for more than 183 days, 2) the gains are effectively connected to a U.S. trade or business, or 3) gains are from the sale of certain timber, coal, or domestic iron ore assets. When these exceptions apply, the NRA is taxed on U.S. source capital gains at the rate of 30 percent.

An NRA is taxed on income effectively connected to a U.S. trade

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or business under the same rules as all other U.S. taxpayers. Income may be reduced by appropriate deductions (connected to the U.S. trade or business) and standard tax rates apply. Because traditional tax rules apply, this is necessarily limited to what constitutes a U.S. trade or business and to what “effectively connected” means.

There is no code definition for the term “U.S. trade or business.” However, it has been held to include providing personal services in the United States, selling products in the United States directly or through an agent, soliciting orders from the United States and then exporting merchandise outside the United States, manufacturing, maintaining a retail store, and maintaining corporate offices in the United States. The meaning of “effectively connected” is highly specific and complex and involves the “force of attraction” rule and “asset-use” and “business-activities” tests.

In general, however, an NRA will be engaged in a U.S. trade or business if the NRA is a general or limited partner in a U.S. partnership engaged in a trade or business. Similarly, a beneficiary of a U.S. estate or trust will be engaged in trade or business if the estate or trust is so engaged.

For real estate, the critical inquiry concerns the nature of the rental income. It is passive if it is generated by a triple-net lease or from lease of unimproved land. If rental income is passive, it is taxed on a gross basis, with no deductions, at a flat rate of 30 percent, with the applicable withholding. The loss of deductions is often tax-prohibitive, and investors should consider electing to treat their passive real property income as income from a U.S. trade or business. However, the election can only be made if the property is generating income. Consequently, if an NRA owns unimproved land that will be developed in the future, he or she should consider leasing the land for some purpose in an attempt to generate income. This will give the NRA the ability to claim deductions from the property and possibly generate a loss carry-forward that will offset income in future years.

A popular planning tool to avoid taxation of real estate income is portfolio interest, which is payable on a debt instrument and is not subject to taxation or withholding. NRAs often try to fit into the portfolio interest rules by lending through equity participation loans or loans with equity kickers. An equity kicker is an addition to a fixed-income security (like a loan) that allows the lender to participate in equity appreciation. This may be accomplished in the form of a conversion option, allowing the lender to convert debt into equity. These provisions usually increase interest rates on a contingent basis to mimic equity participation. NRAs should be aware, however, that in two cases the IRS has successfully argued that portfolio interest “loan” structures were in reality equity investments that produced income subject to taxation and withholding.

If a foreign individual or a foreign corporation owns a U.S. corporation, there are two levels of tax. The U.S. corporation will be subject to the regular income tax on its profits, and there will be a tax on dividends paid to the foreign shareholders, subject to 30 percent withholding.

The so-called branch profits tax replicates this double tax when the U.S. business is owned by a foreign corporation, whether directly, through a disregarded entity, or through a pass-through entity. Under the branch profits tax, the foreign corporation is taxed on its effectively connected income and on any deemed dividends, which are any profits not reinvested in the United States. The branch profits tax applies at the rate of 30 percent but may be reduced by an applicable treaty. The U.S. has treaties covering the branch profits tax with most of the European nations, reducing the tax to between 5 and 10 percent.

The 30 percent tax is onerous, as it applies to a “dividend equivalent amount,” which is the corporation’s effectively connected earnings and profits for the year, less investments the corporation makes in its U.S. assets (money and adjusted bases of property connected with the conduct of a U.S. trade or business). The tax is imposed even if there is no distribution.

The rules applicable to the tax on the disposition of real estate are found in a separate regime known as the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA). Generally, FIRPTA taxes the disposition of a U.S. real property interest (USRPI) as if the NRA were engaged in a U.S. trade or business. This means that the traditional income tax rules that apply to U.S. taxpayers will also apply to the NRA. Purchasers who acquire a USRPI from a NRA are obligated to withhold 10 percent of the amount realized on the disposition.

An interest in real property includes any ownership of land, buildings, mineral deposits, crops, fixtures, personal property used to 1) exploit natural resources, 2) construct improvements, 3) operate a lodging facility, or 4) provide a furnished office to a tenant (including movable walls or furnishings), improvements, leaseholds, or options to acquire any of the above. Ownership interests include fee ownership, co-ownership, leasehold, timeshare, a life estate, a remainder, a reversion or a right to participate in the appreciation of real property or in the profits from real property.

A partnership interest is treated as a USRPI if 1) 50 percent or more of the value of partnership gross assets consists of USRPIs, and 2) 90 percent or more of the value of partnership gross assets consist of USRPIs plus cash and cash equivalents. The disposition of partnership interest will be subject to FIRPTA to the extent such partnership owns USRPIs and will be subject to withholding. A domestic corporation will be treated as a U.S. real property holding corporation (USRPHC) if USRPIs equal or exceed 50 percent of the sum of the corporation’s assets. Disposition of an interest in a USRPHC is subject to the FIRPTA tax and withholding but is not subject to state income tax. This may be compared with the disposition of a USRPI owned directly, which is subject to the lower federal capital gains rate but is also subject to the state income tax.

The disposition of an interest in a domestic corporation will not be subject to these rules if on the date of the disposition the corporation had no USRPIs and all of the gain was fully recognized (no installment sales or exchanges) on the sale of any USRPIs sold within the past five years.

Any NRA (individual or corporation) selling a USRPI is subject to withholding of 10 percent of the amount realized. Withholding applies even if the property is sold at a loss. The withholding obligation is imposed on the purchaser, who must report the withholding and pay over the tax, using Form 8288 within 20 days of the purchase. If the purchaser fails to collect the withholding tax from the foreigner, the purchaser will be liable for the tax plus any applicable penalties and interest. The withheld taxes are later credited against the total tax liability of the foreigner.

Withholding is not required if 1) the seller provides a certificate of non-foreign status, 2) property acquired by the purchaser is not a USRPI, 3) the transferred property is stock of a domestic corporation and the corporation provides a certificate that it is not a USRPHC, 4) the USRPI acquired will be used by the purchaser as a residence and the amount realized by the foreigner on the disposition is $300,000 or less, 5) the disposition is not subject to tax, or 6) the amount realized by the foreigner on the disposition is zero.

**Estate and Gift Tax**

For estate tax purposes, the test is completely different in determining who is an NRA—the inquiry centers around the decedent’s domicile. This is a subjective test that looks primarily at intent. The test considers factors such as the length of stay in the United States; frequency of travel, size, and cost of home in the United States; location of family; participation in community activities; participation in U.S. business and ownership of assets.
in the United States; and voting. A foreigner can be a U.S. resident for income tax purposes but not be domiciled for estate tax purposes. An NRA, whether a non-resident alien or nondonor, is subject to a different transfer tax (estate and gift taxes) regime than a U.S. taxpayer. The estate tax is imposed only on the part of the gross NRA's estate that at the time of death is situated in the United States.39 The rate of NRA's estate tax is the same as that imposed on U.S. citizens and resident aliens, but the unified credit is only $13,000 (equivalent to about $60,000 of property value).39 These harsh rules may be ameliorated by an estate tax treaty. The U.S. does not maintain as many estate tax treaties as income tax treaties, but there are estate tax treaties in place with many of the major European countries, Australia, and Japan.37

The following assets are specifically included by the IRC in the definition of property situated in the United States: 1) shares of stock of a U.S. corporation, 2) revocable transfers or transfers within three years of death of U.S. property or transfers with a retained interest (described in IRC Sections 2035 to 2038), and 3) debt issued by a U.S. person or a governmental entity within the United States (e.g., municipal bonds).38 U.S. property also includes real estate in the United States (if debt is recourse it is ignored—gross value is included, not just equity) and tangible personal property such as works of art, furniture, cars, and currency.39 A beneficial interest in a trust holding U.S. property is also U.S.-situs property.40 U.S.-situs property does not include life insurance proceeds paid on the life of the NRA, bank accounts (unless connected with a U.S. business), portfolio interest loans,44 and shares of stock in a foreign corporation.42

The gross estate is reduced by various deductions relating to the U.S.-situs property. The estate tax returns must disclose all of the NRA's worldwide assets, in order to determine the ratio that the U.S. assets bear to non-U.S. assets. This ratio determines the percentage of allowable deductions that may be claimed against the gross estate.43 When real estate is subject to a recourse mortgage, the gross value of the real estate is included, offset by the mortgage debt.44 This distinction is irrelevant for U.S. taxpayers filing estate tax returns but is very relevant for NRAs for whom debts are subject to apportionment between U.S. and non-U.S. assets and therefore not fully deductible.45

Advance planning can eliminate or reduce the U.S. estate tax obligations of NRAs. For example, U.S. real estate owned by the NRA through a foreign corporation is not included in an NRA's estate. This effectively converts U.S. real property into a non-U.S. intangible asset. Even if the real estate were not initially acquired through a foreign corporation, it may be beneficial to pay an income tax today on the transfer of the real estate to a foreign corporation (usually treated as a sale) to avoid the estate tax in the future.

Gift taxes are imposed on the donor. A NRA donor is not subject to U.S. gift taxes on any gifts of non-U.S. situs property gifted to any person, including U.S. citizens and residents. Citizens and residents, however, must report on Form 3520 gifts from a NRA that are in excess of $100,000.46 Gifts of U.S.-situs assets are subject to gift taxes, with the exception of intangibles, which are not taxable.47 Tangible personal property and real property is situs within the United States if it is physically located in the United States.48 NRA donors are allowed the same annual gift tax exclusion as other taxpayers and are subject to the same rate schedule for gift taxes. However, the lifetime unified credit is not available to NRA donors.49

The primary thrust of estate tax planning for NRAs is through the use of 1) foreign corporations to own U.S. assets, or 2) the gift tax exemption for intangibles to remove assets from the United States. If the NRA dies owning shares of stock in a foreign corporation, the shares are not included in the NRA's estate, regardless of the situs of the corporation's assets. It is important that the corporation have a business purpose and activity, lest it be deemed a sham designed to avoid U.S. estate taxes.50

The gift of an intangible, wherever situated, by an NRA is not subject to gift tax. Shares in U.S. corporations and interests in partnerships or LLCs are intangibles.51 Consequently, real estate owned by the NRA through a U.S. corporation, partnership, or LLC may be removed from the NRA's U.S. estate by gifting entity interests to foreign relatives.

Ownership Structures
An NRA can acquire U.S. real estate using several alternative ownership structures. The NRA's goals and priorities dictate the type of structure that is used. Each alternative has its own advantages and disadvantages. For example, direct investment (real estate owned by the NRA) is simple and is subject to only one level of tax on the disposition. If the real estate is held for one year, the sale is taxed at a 15 percent rate.52 The disadvantages of the direct investment are: no privacy, no liability protection, the obligation to file U.S. income tax returns, and if the NRA dies while owning the property, it is subject to U.S. estate taxes.

Under an LLC or a limited partnership structure, the NRA acquires the real estate through an LLC or an LP. The LLC may be a disregarded entity or a tax partnership for U.S. income tax purposes. This is an improve-
ment over the direct ownership alternative, because this structure provides the NRA with privacy and liability protection and allows for lifetime transfers that escape the gift tax. The obligation to file U.S. income tax returns and the possibility for U.S. estate tax on death remain, however.

Ownership of real estate through a domestic corporation (a C corporation, since a foreign shareholder precludes an S corporation) will afford privacy and liability protection, allow lifetime gift tax-free transfers, and obviate the foreigner’s need to file U.S. income tax returns. Engaging in a U.S. trade or business requires a U.S. tax return; ownership of stock will not trigger a return filing obligation.

There are three disadvantages to the ownership of real estate through a domestic corporation. One is that federal and state corporate income tax at the corporate level will add a second layer of tax. The second is that dividends from the domestic corporation to its foreign shareholder will be subject to 30 percent withholding. The third is that the shares of the domestic corporation will be included in the U.S. estate of the foreign shareholder. Further, on the disposition of the stock in the corporation, the foreign shareholder will be subject to FIRPTA, because the corporation will be treated as a USRPHC. This will require the filing of a U.S. income tax return and 10 percent tax withholding by the purchaser of the shares.

Ownership of the real estate may be by the U.S. corporation directly, or through a U.S. partnership or disregarded entity owned by the corporation. The corporation may even be an LLC that chooses to be taxed as a corporation. In turn, the ownership of the U.S. corporation by the NRA may be direct, or through a foreign partnership or disregarded entity.

Foreign corporation ownership offers the following advantages: 1) liability protection, 2) no U.S. income tax or filing requirement for the foreign shareholder, 3) shares in the foreign corporation are non-U.S. assets not included in the U.S. estate, 4) dividends are not subject to U.S. withholding, 5) no tax or filing requirement on the disposition of the stock, and 6) no gift tax on the transfer of shares of stock.

The disadvantages of using the foreign corporation are 1) corporate level taxes (just like with the domestic corporation), because the foreign corporation will be deemed engaged in a U.S. trade or business, and 2) the foreign corporation will be subject to the branch profits tax, the largest disadvantage of ownership of U.S. real estate through a foreign corporation.

Because the branch profits tax is not always reduced or eliminated by a treaty, the
most advantageous structure for ownership of U.S. real estate by NRAs is a hybrid foreign and U.S. corporation. The NRA owns a foreign corporation that in turn owns a U.S. LLC taxed as a corporation. This structure affords privacy and liability protection, escapes U.S. income tax filing requirements, avoids U.S. estate taxes, allows for gift tax-free lifetime transfers, and avoids the branch profits tax. Distributions from the U.S. subsidiary to the foreign parent are subject to the 30 percent FDAP withholding, but the timing and the amount of this dividend is within the NRAs control.

There are multiple considerations and structures available to foreign investors in U.S. real estate, and no structure is perfect. Each structure presents its own advantages and disadvantages that require analysis in light of the objectives and priorities of each client.

1 With the exception of a few states that restrict foreign ownership of mineral rights, no restrictions are imposed on foreign ownership of U.S. real estate.
2 CORP. CODE §§17451(a).
3 See Jacob Stein, California Registration Requirements for Foreign LLCs, CAL. TAX LAWYER 41 (Summer 2008).
4 Erkenbrecher v. Grant, 187 Cal. 7, 9, 200 P. 641 (1921); Hollywood Cleaning & Pressing Co. v. United States, 470 F. 2d 308 (7th Cir. 1972).
5 CORP. CODE §§15673, 17302. See Jacob Stein, A Practical Take on Charging Orders, 8 BUS. ENT. MAG. 28 (Sept. 2006).
6 U.C.C. §8112.
7 CORP. CODE §17302.
8 I.R.C. §7701(b).
9 I.R.C. §§871(a), 881. Rental income is sourced to where the property is located. I.R.C. §861(a)(4).
10 I.R.C. §1441(a).
11 I.R.C. §871(a)(2).
12 I.R.C. §§871(b), 882.
13 See I.R.C. §§884(h)(2), (3).
14 I.R.C. §875(1).
15 I.R.C. §875(2).
16 I.R.C. §871(a)(1); Treas. Reg. §1.871-7(a)(3).
17 I.R.C. §871(d); Rev. Rul. 92-74, 1992-2 CB 156.
19 I.R.C. §§871(b), 881(c)(1).
20 See, e.g., Farley Realty Corp. v. Commissioner, 279 F. 2d 701 (2d Cir. 1960), Portage Plastics Co. v. United States, 470 F. 2d 308 (7th Cir. 1972).
21 I.R.C. §884(a).
22 Id.
23 Foreign Investment in Real Property Tax Act of 1980, codified at I.R.C. §§897, 1445, 6039C.
24 A USRPI is defined as any interest in 1) real property located in the United States or 2) a domestic corporation that is a “United States real property holding corporation.” I.R.C. §897(c)(1).
25 I.R.C. §897.
26 I.R.C. §897(c); Treas. Reg. §1.897-1(b).
28 Temp. Reg. §1.897-7T.
29 I.R.C. §897(c)(2).
30 I.R.C. §897(a)(1). There are no state law equivalents in the United Kingdom.
31 I.R.C. §897(c)(1)(B); Treas. Reg. §1.897-2(c).
32 I.R.C. §1445.
33 Id.; Treas. Reg. §1.1445-2(d)(2)(i).
35 I.R.C. §2103.
36 I.R.C. §2102(b)(1).
37 This includes tax treaties with Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Norway, Sweden, Switzerland, and the United Kingdom.
38 I.R.C. §2104.
41 I.R.C. §2105.
42 Treas. Reg. §20.2105-1(f).
43 I.R.C. §2105(a)(1), (2).
44 Treas. Reg. §20.2105-7. If the mortgage is non recourse, only the net value of the property is included in the estate.
45 Treas. Reg. §20.2106-2. Apportionment is also possible only if worldwide assets are disclosed on the estate tax return.
46 I.R.S. Notice 97-34, 1997-1 C.B. 422.
47 I.R.C. §2501(a)(2).
48 Treas. Reg. §25.2511-3(b).
49 I.R.C. §2505(a).
50 See, e.g., Jackson v. Commissioner, 233 F. 2d 289 (2d Cir. 1956).
51 Interest is an intangible if the partnership is a distinct legal entity and survives the death of its partners.
52 This includes tax treaties with Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Norway, Sweden, Switzerland, and the United Kingdom.
53 I.R.C. §1(h).
54 I.R.C. §1361(b)(1)(C).
In the aftermath of the Great Recession of the late 2000s, many retailers shuttered their stores, went out of business, and, in some cases, filed for bankruptcy. As for the retailers that survived, many imposed an immediate freeze on their expansion plans, opting instead to wait and see how and when the market would recover. Gradually, over the last few years, the expansion freeze has been thawing, and sanguine retailers have warmed up to the notion of reentering the market. But their return comes with new demands. Aside from lower rents, retailers are demanding protections in their leases that once only the big anchor tenants could obtain. Now, tenants of every size are clamoring for these anchor protections, and landlords, still reeling from the recent economic collapse and a paucity of new deals, are reluctantly acquiescing.

One significant demand is the exclusive right to sell certain products in a shopping center. This concept, while easy to understand, is relatively difficult to draft in a way that is enforceable and that addresses each party’s concerns. From a tenant’s perspective, the provision should prohibit the landlord from allowing another tenant to compete with its business. On the other hand, landlords want the flexibility to lease space in their centers to a diversified tenant mix without unduly excessive or unintended restrictions.

Defining the Exclusive
With that in mind, the first and primary issue to consider is how to define the scope of the exclusive. Some exclusives focus on restricting a type of business, such as a “drug store,” while others focus on restricting certain types of products, such as “groceries.” In either case, problems can arise. For example, an exclusive right to operate a “drug store” has been held to prevent other tenants from selling prescription drugs, but not health and beauty products, which many people likely expect to find in a drug store. The exclusive right to operate a furniture store has been held to preclude a competitor from selling carpets, rugs, and linoleum, products that many people do not consider to be furniture. An exclusive for a martial arts studio has been

More retailers are demanding exclusive rights, but they remain challenging to define and enforce.
held to preclude a fitness facility featuring boxing and kick-boxing. An exclusive right to sell groceries has been held to prevent the sale of food and beverage items, but not alcoholic beverages, paper products, or household cleaners.

In one recent case, Winn-Dixie Stores, Inc. v. Big Lots Stores, Inc., the court analyzed over 100 of Winn-Dixie’s leases spanning the states of Florida, Alabama, Georgia, Mississippi, and Louisiana, and determined that an exclusive on “groceries” was ambiguous. Winn-Dixie sued the family of companies operating under the trade names Dollar Tree, Dollar General, and Big Lots. The defendant argued that “groceries” should include only food items but not any beverages, snacks, or candy, while Winn-Dixie argued that “groceries” should include all food items and all beverage products, as well as nonfood items such as paper products and household cleaners. In rejecting each side’s interpretation, the court arrived at its own definition to include only food items and beverages but not alcoholic beverages. Interestingly, the federal court in Winn-Dixie declined to follow a Florida state court’s interpretation of the identical exclusive provision prohibiting the sale of groceries. The state court concluded the term “groceries” should be interpreted to include more than just food. In distinguishing the two cases, the federal Winn-Dixie court explained that the leases it analyzed dated back to 1957, while the single lease analyzed by the state court was from 1986. This led the court to determine that while “groceries” may have been intended by the parties to cover nonfood items in the 1986 lease, the term “groceries” in the 1957 leases was not intended to cover nonfood items. The court based its decision on its determination that the offerings of groceries have evolved over time. Although the court’s analysis may appear to be making a distinction without a difference, the lesson learned is that it is imperative to define the restricted products with as much specificity as possible, or a judge may decide on the definition instead.

Exclusive Carve-Outs

Second, most exclusives that focus on the type of products sold (as opposed to focusing on the type of business operated) include carve-outs allowing other tenants to sell a certain percentage of the excluded products without such sales being deemed a violation. A common distinction is the sale of the restricted products on an incidental basis (which is permitted) versus on a primary basis (which is prohibited). As the Winn-Dixie court concluded, however, the terms “incidental” and “primary” may be too ambiguous to enforce. Does “primary” mean 51 percent of the total gross sales, or does it require more? What if a tenant’s most popular product amounts to 30 percent of its total sales—would that product be considered primary to that tenant’s business and thus a violation of another tenant’s exclusivity? To avoid these types of questions, it is a better, but still problematic, practice to specify an actual percentage of gross sales that would not be considered a violation. Often, the parties agree to allow other tenants to sell the exclusive product in an amount somewhere in the range of 10–25 percent (depending on the product) of such other tenants’ gross sales without such sales being deemed a violation.

Tying a carve-out to a percentage of gross sales, however, raises other concerns, such as landlord audit rights, measuring periods, and damage claims. First, a landlord should provide itself with the right to audit its tenants’ gross sales—a provision that is sometimes omitted from leases that do not require the payment of percentage rent. When audit rights are included in a lease, consideration should be given to whether the tenant should be specifically required to maintain its accounting records by separating out different product lines. Not all tenants structure their accounting in a way that allows easy verification, however, so drafting a lease provision to require it may not work. It is doubtful that a tenant will change its company-wide accounting methods to accommodate a single lease requirement. If that issue is resolved, however, the next question is what measuring period to use. Should the tenant count its sales on a daily, monthly, or annual basis? Most leases are silent on this issue. What if there is a restriction on selling 15 percent of an excluded product but the offending tenant’s gross sales of the restricted product are 12 percent in one month and 17 percent in another month? Should the tenant be allowed to average the two months and thus avoid being in violation of the exclusive? An argument can be made that the sales should be measured on an annual basis, since that is the typical measuring period for percentage rent in leases. If the sales are measured annually, however, it effectively means that a tenant that bargained for an exclusive may have to wait 12 months before it can demonstrate that another tenant is violating the exclusive.

To avoid these practical issues, some tenants prefer to measure a violation by the amount of sales floor area used to sell a restricted product. For example, a lease could provide that a tenant will not be considered to be in violation of the exclusive if it uses less than 10 percent of its sales floor area to sell the restricted product. But measuring floor area is not always straightforward either. In Winn-Dixie, Big Lots argued that only the footprint of the display unit should be counted toward the carve-out, while Winn-Dixie argued that in addition to the display unit, half the aisle space should also be counted toward the sales area. The court agreed with Big Lots and concluded that aisle space should not be included. To remove these types of uncertainties and avoid leaving it up to the court to decide, parties should expressly specify whether the calculation of the offending floor area should include aisle space in addition to the floor area taken up by the display unit itself.

Remedies

Once all of the issues with respect to defining what constitutes a violation of an exclusive use are addressed, next up is determining the remedies for the tenant in the event of such a violation. Many landlords are willing to protect a tenant when the landlord is directly to blame for a violation by, for example, knowingly signing a lease with a competitor. If the violation, however, is caused by what is referred to as a rogue tenant (one that does not have the right to sell the exclusive products under its lease but does so anyway), landlords are reluctant to provide a tenant with remedies. A landlord does not want to be considered to be in breach of its lease if it has not directly done anything wrong. Most tenants recognize this and are willing to make a distinction between these two types of violations by negotiating different remedies for each type of violation. For instance, if the landlord is directly to blame, the tenant’s remedy applies right away. If the violation is caused by a rogue tenant, on the other hand, the landlord may require notice along with an opportunity to cure the violation by pursuing an injunction against the rogue tenant to force it to stop the violation. In the case of a rogue tenant violation, tenants are usually willing to give the landlord a reasonable period of time to cure the violation, after which the tenant will expect to get some sort of relief.

If a violation is established, it is possible that a tenant could terminate its lease and be relieved of all of its future obligations, as shown in Medico-Dental Building Company v. Horton & Converse, in which the court held that a landlord violated a tenant’s exclusive right to sell drugs when it leased other space in the building to a pharmacist. The court held that the tenant’s exclusive was a material part of the consideration that induced the tenant to enter into the lease, so the covenant to pay rent and the restrictive covenant were interdependent. Consequently, the landlord’s breach of the restrictive covenant allowed the tenant to vacate the premises without further liability for rent. Under some circumstances, a tenant may also recover lost profits, although many landlords require tenants to waive rights to recover
lost profits for a landlord’s breach. Proving damages, however, may be a difficult and cumbersome task, and in some cases, too speculative for a court to determine.\textsuperscript{14}

\textbf{Liquidated Damages}

To provide certainty, many landlords and tenants insert liquidated damages provisions providing the tenant with a fixed amount of damages following a violation of the tenant’s exclusive. Under California law, there is a presumption of validity for liquidated damages clauses in commercial leases, unless the party seeking to invalidate the provision shows that the provision was unreasonable under the circumstances existing at the time the contract was made.\textsuperscript{15} The reasonableness of the provision must be judged “at the time the contract was made and not as it appears in retrospect.”\textsuperscript{16} Thus, the validity of a liquidated damages provision is not dependent on the amount of the damages actually suffered; rather, all of the circumstances existing at the time the contract was entered into must be considered to determine whether the liquidated damages provision is reasonable and therefore enforceable. “The amount set as liquidated damages ‘must represent the result of a reasonable endeavor by the parties to estimate a fair average compensation for any loss that may be sustained.’”\textsuperscript{17}

With this in mind, it is common for national retailers to request liquidated damages in the form of a 50 percent rent drop upon a violation of the exclusive.\textsuperscript{18} Tenants should be careful, however, in negotiating this remedy too aggressively, because in some jurisdictions a full abatement of rent has been ruled an unenforceable penalty.\textsuperscript{19} Some landlords seek to include a sales test so that the tenant’s rent is reduced only if the tenant can prove that its sales have dropped as a result of the violation of its exclusive. Sales tests (which are also used in other areas of retail leasing), however, raise many complications that, some tenants argue, make using them unfair. Other variables not connected to a competitor’s presence may contribute to an increase or decrease in a tenant’s yearly gross sales.

Once the parties have agreed upon a liquidated damages amount, the next matter to determine is the length of time the tenant will be entitled to such damages. It is common for national retailers to pay reduced rent for anywhere from 6 to 12 months after a violation, followed by what is commonly referred to as a fish-or-cut-bait provision under which the tenant either reverts to paying full rent in spite of the violation or terminates the lease.

\textbf{Monetary Damages}

Aside from recovering damages from the landlord, a tenant may also want damages from the offending tenant as well as specific enforcement of its exclusive. Whether a tenant has a right to sue another tenant for violation of an exclusive will vary depending on the jurisdiction. For example, Florida, Georgia, and Alabama allow tenants to sue other tenants directly, but Mississippi does not unless there is privity of estate between the two tenants.\textsuperscript{20}

In California, there is no case law that addresses this issue directly on point; however, in several cases a tenant has successfully pursued the offending tenant, at least indirectly. In \textit{Hildebrand v. Stonecrest Corporation}, the landlord agreed that it would not permit the sale of drugs, medicines, or cosmetics in the supermarket located in the shopping center.\textsuperscript{21} When the supermarket began selling these items, the tenant sued the landlord and the supermarket. The court awarded the tenant a judgment against the landlord but also entered a judgment in favor of the landlord against the supermarket in the same amount as the tenant’s judgment against the landlord.\textsuperscript{22} In \textit{Lewis v. Alpha Beta Company}, a liquor operator sued its cotenant and the landlord for a breach of the exclusive right to sell alcoholic beverages.\textsuperscript{23} The landlord then filed a cross-complaint against the cotenant. The court issued a permanent injunction against the cotenant based on the landlord’s cross-complaint, which rendered the liquor operator’s suit against its cotenant moot. Nonetheless, the court determined that although formally the judgment was in favor of the landlord alone, in reality the liquor operator was also a prevailing party, and the operator was therefore entitled to attorney’s fees.\textsuperscript{24}

There can be many difficulties in enforcing damage claims by one tenant directly against another. These difficulties were highlighted in \textit{Winn-Dixie} when the court heard expert testimony from several economists who provided different economic models and regression analyses on all of the leases. One expert testified that whenever Big Lots opened up a store next to Winn-Dixie, Winn-Dixie suffered, on average, a 6.5 percent loss of sales at that store. Using a different approach called the “gravity model,” another expert testified that the lost sales could exceed 30 percent per store. Another expert testified that “if
not have enough of an incentive to stop violating the exclusive. After all, once an injunction is issued, the tenant is merely required to stop violating the exclusive; there is no other penalty. Obtaining an injunction in these circumstances would amount to a pyrrhic victory for the tenant that bargained for an exclusive. For example, among the leases under which Winn-Dixie “won” an injunction, Big Lots was merely ordered to comply with the exclusive by reducing the size of the footprint of its grocery sales. After years of litigation, during which time Big Lots continued to violate Winn-Dixie’s exclusive, Winn-Dixie was merely restored to the position it was in before Big Lots violated the exclusive, after presumably having lost sales and having incurred substantial legal fees.

**Notice**

In those jurisdictions in which a tenant has the right to sue another tenant for the violation of an exclusive, notice is typically required. To satisfy the notice requirement, a tenant should record a memorandum of the lease that specifically refers to its exclusive rights. By doing this, the tenant provides constructive notice of its exclusive use to all incoming tenants of the center. Practically, however, except for some big-box tenants, it is not common for potential tenants to search the chain of title before entering into leases to determine whether an intended use will be restricted by another tenant’s exclusive. It will be interesting to see if a court refuses to impose constructive knowledge on an unsophisticated tenant, if not a big-box tenant. The Winn-Dixie court noted that the notice requirement was satisfied in that case because Big Lots was an experienced commercial tenant with over 7,800 stores in 32 states and because Big Lots was aware that Winn-Dixie typically secured exclusives. The court deemed that these facts imposed an obligation on Big Lots to inquire about the existence of an exclusive.27

To remove any doubt of whether a tenant has notice of another tenant’s exclusive rights, some landlords insert provisions in the lease to provide actual notice by informing the tenant that it is subject to existing exclusives affecting the center, and listing the exclusives on an exhibit. While this may solve the problem of notice, it may also result in the unintended consequence of alerting the tenants that the landlord is willing to grant exclusives to its tenants.

**Successor Liability**

It should be noted that not only will the original landlord be subject to the exclusive rights it grants to its tenants but also the landlord’s successors will be responsible for upholding a tenant’s exclusive use after the successor
landlord takes over the property. For example, in *Carter v. Adler*, the tenants had exclusive rights for “Grocery, Delicatessen, Meats, Produce, Fish and Poultry” within a shopping center. The land was later purchased by a new landlord who also acquired an adjacent parcel for the purpose of combining the two parcels and developing the combined area into one supermarket. The court ultimately found that the successor landlord was prevented from operating a supermarket on the adjacent parcel because of the tenant’s exclusive. Although the *Carter* court did not directly address any notice requirement, Section 1468 of the California Civil Code appears to require that a restrictive covenant be recorded in the public records to be binding on a successor owner.

**Antitrust Considerations**

As a final note, exclusive use clauses have been held to not violate the federal Sherman Antitrust Act. Courts have applied the “rule of reason” contained in the act and have consistently upheld restrictive covenants when the restrictions do not have a substantial adverse effect on competition.

Exclusivity provisions are rising in popularity with tenants of all sizes in the retail industry. Drafting these provisions requires careful thought and consideration of a myriad of issues. Without specificity, such provisions are ripe for attack and may lead to unpredictable outcomes. In light of the recent *Winn-Dixie* case, special attention should be given to defining the scope of the exclusive, establishing carve-outs, and identifying available remedies in different jurisdictions, such as monetary damages and injunctive relief.1

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5. Id. at *6.
8. Id. at *9 and *16.
9. Id. at *7. The Florida state court in the prior case adopted Winn-Dixie’s position.
12. See id. at 420.
13. *See id.* at 420.
17. Id. (citations omitted).
18. *See*, e.g., *Red Sage Ltd. P’ship v. Despa Deutch Sparkassen Immobilien-Anlage-Saelschaft MBH*, 254 F. 3d 1120, 1130 (2001). See also *Valentine’s, Inc. v. Ngo*, 251 S.W. 3d 352, 355 (Mo. Ct. App. 2008), in which the court upheld a liquidated damages provision in the amount of $100,000, even though that amount was not directly related to any actual loss of profits that the tenant would have suffered due to the violation.
23. Id. at 163-64.
25. Id. at 33.
27. Id.
28. *See id.* at *16.
30. Id.
31. Id. at *9.
With foreclosures in the United States rising to over 3.9 million since 2008, the residential mortgage industry has come under public scrutiny. New legislative and regulatory enactments have followed, and mortgage servicing practices are undergoing significant changes. Under the National Mortgage Settlement (NMS) negotiated by a coalition of state attorneys general and federal agencies, five major mortgage servicers agreed to abide by new servicing standards of conduct and allocate significant financial resources to loan modifications.

Building on the settlement, California enacted the Homeowner’s Bill of Rights (HOBR), which imposes many of the same servicing standards on other residential mortgage servicers. At the federal level, the Consumer Financial Protection Bureau, an agency created by the Dodd–Frank Wall Street Reform and Consumer Protection Act, recently proposed new regulations that would require compliance with many of the same standards. Collectively, the result will be a host of changes in mortgage servicing and foreclosure practices in California, which will have a significant effect on homeowners and those in the residential mortgage industry.

In 2010, a joint federal and state investigation was initiated after major mortgage servicers were alleged to have filed false affidavits in judicial foreclosure proceedings, a practice dubbed robo-signing. As later articulated in the complaint that resulted from the investigation, bank employees were accused of repeatedly “preparing, executing, or filing affidavits in foreclosure proceedings without personal knowledge of the assertions in the affidavits and without review of any information or documentation to verify the assertions in such affidavits.”

Although robo-signing was the initial focus, the investigation quickly expanded into other servicing practices. In 2012, the United States, the state attorneys general of every state except Oklahoma, and the District of Columbia filed a complaint in the U.S. District Court for the District of Columbia.

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of Columbia against five major mortgage servicers: Citibank, JP Morgan Chase/Washington Mutual, Bank of America/Countrywide, Wells Fargo/Wachovia, and Ally Financial/GMAC Mortgage, L.L.C. In addition to robo-signing, the complaint included allegations of dual-tracking, which is the process of continuing to pursue foreclosure while concurrently communicating with the borrower about loan modification options. To settle the complaint, the five major servicers agreed to enter into consent judgments, collectively referred to as the NMS.

The nonmonetary terms of the NMS are broad, imposing numerous new mortgage servicing requirements on the settling servicers. In order to prevent robo-signing, the NMS mandates that a servicer take appropriate actions to verify its right to foreclose. For example, a servicer must review “competent and reliable evidence” to substantiate the borrower’s default and the right to foreclose before a loan is referred to nonjudicial foreclosure. Further, in all states, a servicer has to send the borrower a “statement setting forth facts supporting Servicer’s or holder’s right to foreclose” no later than 14 days before the loan is referred to a foreclosure attorney or trustee. The statement must also include such additional information as an “itemized plain language account summary” and a “statement to the borrower outlining loss mitigation efforts undertaken with respect to the borrower prior to foreclosure referral.”

The NMS imposes specific obligations on each servicer in handling a borrower’s loan modification request. Potentially eligible borrowers must be notified of “currently available loss mitigation options prior to foreclosure referral” and upon timely receipt of a completed application, a servicer has to evaluate the borrower’s qualification for “all available loan modification options.”

All “initial denials of an eligible borrower’s request for first lien loan modification” are required to be evaluated by an independent entity or an employee who was not involved with the particular loan modification. When a first mortgage loan modification is denied after independent review, the servicer is required to send a written nonapproval notice to the borrower explaining the reasons for denial and what factual information was considered. The borrower has a right to appeal and obtain an independent review of the denial. If the servicer denies the borrower’s appeal, the servicer’s appeal denial letter “shall include a description of other available loss mitigation, including short sales and deeds in lieu of foreclosure.”

The NMS also restricts dual-tracking by prohibiting a servicer from referring a loan to foreclosure while a completed loan modification application is pending. A servicer must obey time limits before foreclosing if the borrower, for example, filed an incomplete application, accepted a loan modification but failed to perform, appealed a loan modification request that was denied, or submitted an application after the loan was referred for foreclosure. To improve communication between servicers and homeowners, a servicer is required under the NMS to establish an “easily accessible and reliable single point of contact (SPOC) for each potentially-eligible first lien mortgage borrower.” Servicers must also initiate “outreach efforts to communicate loss mitigation options for first lien mortgage loans to all potentially eligible delinquent borrowers.” However, the use of “nothing more than prerecorded automatic messages...shall not be sufficient” if the messages fail to result in contact between the borrower and the servicer.

The nonmonetary provisions extend to imposing measures to deter community blight caused by neglected real-estate-owned properties; requiring regular quality assurance reviews of documents submitted in judicial and nonjudicial foreclosure proceedings to ensure accuracy and compliance with applicable law and the NMS; establishing oversight and management of third-party providers such as foreclosure firms, law firms, foreclosure trustees, and subservicers; addressing second lien loan modifications, short sales, and bankruptcy; and protecting military personnel.

The NMS

The official NMS Web site states that from a monetary standpoint, the settlement is “the largest consumer financial protection settlement in US history.” The settling servicers agreed to collectively dedicate $20 billion in financial relief for borrowers. The agreement earmarks at least $10 billion to reducing principal balances for borrowers who owe more than the current value of their homes; at least $3 billion to a refinancing program for borrowers who are current on their mortgages but under water; and up to $7 billion for other forms of relief, including forbearance of principal payments by unemployed borrowers, antiblight programs, short sales and transitional assistance, and benefits for military service members. Servicers agreed under the NMS to pay a total of $5 billion to the federal government and various states, including California. Of this amount, approximately $1.5 billion will be used to establish a Borrower Payment Fund to provide cash payments to borrowers whose homes were foreclosed between and including January 1, 2008, and December 31, 2011. Borrowers will have to file a claim online or by mail by no later than January 18, 2013. They must show that they were not offered loss mitigation or were otherwise improperly foreclosed on and that they meet other criteria.

The NMS has significant enforcement provisions. For example, it has created a monitor whose duty is to oversee the servicers and ensure compliance with the consent judgments. Each participating servicer must file regular reports with the monitor, detailing compliance. Based on these reports and independent oversight, the monitor must communicate its findings to the servicers, the U.S. District Court, and a monitoring committee of state attorneys general and federal officials. According to the monitor’s first status report, which covers March 1, 2012, through June 30, 2012, the settling servicers provided nearly 140,000 homeowners with a total of $10.6 billion in relief. If a servicer fails to comply with the NMS, a party to the applicable consent judgment or the monitoring committee can file an enforcement action and seek injunctive relief and/or civil penalties.

While the NMS contains broad provisions releasing each servicer from any claim brought by any state attorney general or banking regulator based on past misconduct involving mortgage loan servicing, foreclosure preparation, and mortgage loan origination services, many other potential claims are not addressed. Notably, the releases cover only the named servicers. They do not extend to third parties that may have provided default or foreclosure services for the settling parties—for example, Mortgage Electronic Registration Systems, Inc. In addition, securitization claims are not addressed, including any claims of state and local pension funds related to the formation, marketing or offering of mortgage-backed securities. Other claims that are not released include violations of state fair lending laws, criminal law enforcement, claims of state agencies having independent regulatory jurisdiction, claims of county recorders for fees, and actions to quiet title to foreclosed properties. The releases also do not preclude individuals or business entities from pursuing their own claims.

Lastly, the NMS contains a sunset provision. The consent judgments and the servicing standards incorporated within them “shall retain full force and effect” for only three and a half years from the date of entry of the judgments.
several bills were enacted that are collectively called the HOBR.32 The HOBR explicitly states that its provisions do not obviate or supersede the obligations of the signatories to the federal NMS.33 Beginning on January 1, 2013, the HOBR provides that a mortgage servicer,34 mortgagee, trustee, beneficiary, or authorized agent “may not record a notice of default” (NOD) under certain deeds of trust, which is a legal prerequisite to a nonjudicial foreclosure sale,35 until several new requirements are met.36

For banks and other institutions that, during the immediately preceding annual reporting period, as established with their primary regulator, foreclosed on 175 or fewer California residential real properties, the HOBR prohibits a mortgage servicer, mortgagee, trustee, beneficiary or authorized agent from recording a notice of default until two prerequisites have been met.37 First, at least 30 days must pass after either 1) the mortgage servicer made initial contact with the borrower, by telephone or in person, to “assess the borrower’s financial situation and explore options for the borrower to avoid foreclosure,” or 2) the servicer satisfied certain specific due diligence requirements in attempting to reach the borrower.38 This is similar to those provisions of Civil Code Section 2923.5 that were enacted in 2008 and had been set to expire on January 1, 2013. Second, if the borrower has submitted a “complete application”39 for a first mortgage loan modification, the mortgage servicer must issue a “written determination” regarding the borrower’s eligibility for the loan modification that the borrower has requested.40

The HOBR defines a “borrower” as any natural person who is a mortgagor or trustee and who is potentially eligible for any federal, state, or proprietary first lien loan modification or other available loss mitigation option offered by, or through, his or her mortgage servicer. However, some individuals are excluded, such as those who have filed for bankruptcy.41 In addition, the provisions only apply to first lien mortgages or deeds of trust that are secured by owner-occupied residential real property containing no more than four dwelling units.42

For banks and other institutions that foreclosed on more than 175 residential real properties in California during the immediately preceding annual reporting period, additional requirements must be met before a NOD can be recorded.43 In addition to meeting the requirements imposed on those foreclosing on 175 or fewer residential properties,44 a mortgage servicer with more than 175 foreclosures must also provide each borrower with written information on the rights of borrowers who serve in the military or are a military dependent.45 The mortgage servicer must also advise each borrower about his or her right to request information, including a copy of the promissory note, a copy of the deed of trust, and a copy of the borrower’s payment history since the borrower was last less than 60 days past due.46 Dual-tracking is banned for all mortgage servicers. Under the HOBR, mortgage servicers can no longer record a NOD while a borrower has an application pending for a loan modification.47 Instead, the mortgage servicer must first make a written determination that the borrower is ineligible.48

For banks and other institutions that exceed the threshold of 175 residential property foreclosures, the written notice denying the loan modification must identify the reasons for the denial and provide instructions on how to appeal the denial.49 The servicer is prohibited from recording a NOD until at least 31 days have passed after the borrower has been notified in writing of the denial and no appeal has been received.50 If the borrower appeals the denial, the servicer is prohibited from recording a NOD until the later of 15 days after the denial of the appeal or 14 days after a first lien loan modification is offered after appeal but declined by the borrower, or, if a first lien loan modification is offered and accepted after appeal, the date on which the borrower fails to timely submit the first payment or otherwise breaches the terms of the offer.51 The mortgage servicer is also required to acknowledge receipt in writing of any document related to a first lien loan modification application.52 Once a NOD is recorded, the mortgage servicer must pro-

The California Attorney General’s office is authorized to impanel a special statewide grand jury “to investigate, consider, or issue indictments in any matters in which there are two or more activities, in which fraud or theft is a material element, that have occurred in more than one county and were conducted either by a single defendant or multiple defendants acting in concert.”
The Los Angeles County Bar Association certifies that this activity has been approved for Minimum Continuing Legal Education credit by the State Bar of California in the amount of 1 hour.

1. Which of the following was not a party to the National Mortgage Settlement (NMS)?
   A. Ally Financial, Inc.
   B. Oklahoma.
   C. Citibank, N.A.
   D. California.
   
2. “Robo-signing” is:
   A. Filing false affidavits in foreclosure proceedings.
   B. Addressed by the NMS.
   C. Addressed by the California Homeowners Bill of Rights (HBOR).
   D. All of the above.
   
3. “Dual-tracking” is a process in which a mortgage servicer first reviews and considers a borrower’s loan modification application before taking any steps to begin a nonjudicial foreclosure.
   True
   False
   
4. Under the NMS, when a first mortgage loan modification is denied by a settling servicer after an independent evaluation, the borrower does not have any right to appeal the denial.
   True
   False
   
5. The NMS requires the settling servicers to establish a single point of contact for each potentially eligible first lien mortgage borrower.
   True
   False
   
6. The terms of the NMS include funds allocated to:
   A. Reductions of principal balances for underwater borrowers.
   B. Forbearance of principal payments by unemployed borrowers.
   C. Payments to the federal government and certain states, including California.
   D. All of the above.
   
7. The NMS created a monitor whose duty is to oversee the servicers and ensure compliance with the consent judgments.
   True
   False
   
8. The deadline for a borrower whose home was foreclosed upon between and including January 1, 2008, and December 31, 2011, to file a claim seeking monetary relief is January 18, 2014.
   True
   False
   
9. The NMS terms require the settling servicers to comply with the servicing standards set forth therein as of December 31, 2020.
   True
   False
   
10. The California HBOR states that its terms supersede the terms of the NMS.
    True
    False
    
11. Under the California HBOR, a “borrower” is any natural person who is a mortgagor or trustor and who is potentially eligible for any federal, state, or proprietary first lien loan modification.
    True
    False
    
12. Some requirements that the California HBOR imposes on a bank depend on the number of foreclosures conducted by a bank in all 50 states in the immediately preceding annual reporting period as established by the bank’s primary regulator.
    True
    False
    
13. Effective January 1, 2013, in California, if a borrower has submitted a “complete application” for a first mortgage loan modification, the mortgage servicer must, at a minimum, issue a “written determination” regarding the borrower’s eligibility for the requested loan modification before recording a Notice of Default.
    True
    False
    
14. Under the California HBOR, mortgage servicers that foreclosed on 175 or fewer California residential real properties in the immediately preceding annual reporting period are not required to have a single point of contact for borrowers.
    True
    False
    
15. In 2013, whenever a trustee’s sale in California is postponed for a period of at least 30 business days pursuant to Civil Code Section 2924g, a mortgagee, beneficiary, or authorized agent shall provide written notice to a borrower regarding the new sale date and time within five business days.
    True
    False
    
16. The California HBOR states that the following remedies are available for violation of certain of its terms, assuming certain conditions are satisfied:
   A. Injunctive relief.
   B. Recovery of actual economic damages.
   C. Reasonable attorney’s fees and costs to a prevailing borrower.
   D. All of the above.
   
17. Under the California HBOR, a tenant or subtenant under a month-to-month or periodic tenancy leasing a rental property that is sold in foreclosure is entitled to receive 60 days’ written notice to quit.
    True
    False
    
18. If a tenant is in possession under a fixed-term residential lease entered into before transfer of title at the foreclosure sale, the California HBOR states that the tenant shall have the right to possession until the end of the lease term.
    True
    False
    
19. The California HBOR does not contain any law enforcement provisions.
    True
    False
    
20. The Dodd-Frank Wall Street Reform and Consumer Protection Act established the:
   A. Settlement monitor for the NMS.
   B. Mortgage Fraud Investigation Department.
   C. Consumer Financial Protection Bureau.
   D. None of the above.
vidual or team of personnel each of whom has the ability and authority to perform the responsibilities” required by law.60 Further, the servicer has to “ensure that each member of the team is knowledgeable about the borrower’s situation and current status in the alternatives to foreclosure process.”61

In a departure from prior law, entities are barred from recording or causing to be recorded a NOD, or otherwise initiating the foreclosure process, unless they hold “the beneficial interest under the mortgage or deed of trust, or [are] the original trustee or the substitute trustee under the deed of trust, or the designated agent of the holder of the beneficial interest.”62 Further, for trustee’s sales, a requirement is added that whenever a trustee’s sale is postponed for a period of at least 10 business days pursuant to Civil Code Section 2924g, a mortgagee, beneficiary, or authorized agent shall provide written notice to the borrower within five business days of the postponement.63

In addition to civil penalties that a governmental entity may pursue for violating the provisions governing declarations in NODs, the HOBR also contains other significant enforcement mechanisms. If a trustee’s deed upon sale has not yet been recorded, a borrower is entitled to bring an action for injunctive relief to enjoin material violations of certain aspects of the law.64 On the other hand, if the trustee’s deed upon sale has been recorded, then the borrower can bring an action for “actual economic damages” resulting from the violation if it was not corrected or remedied before the trustee’s deed was recorded.65 If the court finds that the material violation was intentional, reckless, or resulted from willful misconduct, the court may award the borrower treble the actual damages or statutory damages of $50,000.66 A prevailing borrower may also be awarded reasonable attorney’s fees and costs.67 Some of the provisions of the HOBR sunset on January 1, 2018, but at that time, other similar provisions become effective.

Evictions, Law Enforcement, and Blight

The HOBR also includes several other new California laws. One addresses evictions of residential tenants in possession of foreclosed residential properties. A tenant or subtenant under a month-to-month or periodic tenancy leasing a rental property that is sold in foreclosure is entitled to receive 90 days’ written notice to quit, rather than the 60 days’ notice provided under prior law.68 Tenants in possession under a fixed-term residential lease entered into before transfer of title at the foreclosure sale “shall have the right to possession until the end of the lease term, and all rights and obligations under the lease shall survive foreclosure…”69 The foregoing does not apply if, for example, the purchaser will occupy the house as a primary residence, the fixed-term lease was entered into with the mortgagor or a parent, child, or spouse of the mortgagor, or the fixed-term lease was not the result of an arms-length transaction.70

Various law enforcement provisions applicable to mortgage and foreclosure-related crimes are enhanced. The California Attorney General’s office is authorized to impanel a special statewide grand jury “to investigate, consider, or issue indictments in any matters in which there are two or more activities, in which fraud or theft is a material element, that have occurred in more than one county and were conducted either by a single defendant or multiple defendants acting in concert.”71 This would include the ability to investigate and indict perpetrators of financial crimes involving victims in multiple counties. The time for prosecuting some misdemeanors relating to, for example, engaging in unlawful loan modification activities or providing mortgage loan originator services without a license, is extended. Specifically, prosecution of such violations must be commenced within “three years after discovery of the commission of the offense, or within three years after completion of the offense, whichever is later.”72

Finally, the HOBR makes permanent some laws relating to real property blight, including Civil Code Section 2922.3. This statute requires a legal owner to maintain vacant residential property purchased by that owner at a foreclosure sale, or acquired by that owner through foreclosure under a mortgage or deed of trust, or else face governmental penalties.73 However, new homeowners are given additional time in which to abate any violation for a residential property foreclosed on or after January 1, 2008, and before an enforcement agency could take action.74

New Dodd-Frank Regulations

At the federal level, the Dodd-Frank Act, enacted in 2010 in response to the financial crisis, established the Consumer Financial Protection Bureau (CFPB). The CFPB was directed to “regulate the offering and provision of consumer financial products or services under the Federal consumer financial laws.”75

Following the execution of the NMS, the CFPB issued two Notices of Proposed Rulemaking, including draft regulations, that are similar to some NMS provisions. One proposed regulation would impose requirements relating to early intervention with delinquent borrowers and obligate servicers, among other things, to make a good faith effort to notify borrowers of loss mitigation options.76 In addition, this draft regulation would require “continuity of contact” with delinquent borrowers and regulate the loss mitigation procedures applicable to servicers that offer such options to borrowers. The other proposed regulation would impose certain duties on servicers that make loss mitigation options available to borrowers in the ordinary course of business related to evaluation of borrower applications for these options.77 As of November 2012, the draft rules were still out for public comment, and it was unknown when the CFPB would promulgate final rules, if at all. If any rules are adopted, one issue likely to arise is whether they would preempt state statutes like the HOBR.

Regardless of whether a mortgage servicer is a party to the NMS, the provisions negotiated by the five major servicers in that settlement are likely here to stay in the form of new state laws and proposed federal regulations affecting California foreclosures. The practical effect of the new provisions is yet to be seen, but undoubtedly borrowers and the residential mortgage industry should anticipate significant changes in the way that they interact and how their business relationships are structured.


24 See, e.g., id., exhs. F, G, H. See also Executive Summary, supra note 5, at 4.


26 Ally Consent Judgment, exhs. F, G, H.


28 See also Executive Summary, supra note 5, at 4.

29 Id.

30 CIV. CODE §2923.4(b). See also CIV. CODE §2924.12(c).

31 See, e.g., Ally Consent Judgment, exh. E, at §K.

32 The California HOBR includes AB 278 and SB 900 (servicing and foreclosure requirements), AB 2314 (blight and crime prevention), AB 2610 (protections for tenants in foreclosed properties), AB 1930 (fraud issues), and SB 1474 (multijurisdictional fraud and crimes).

33 CIV. CODE §2923.4(b). See also CIV. CODE §2924.12(c).

34 CIV. CODE §2920.5(a) (definition of “mortgage servicer”).

35 CIV. CODE §2924(a)(1).

36 CIV. CODE §§2923.5(a), 2924.18(b).

37 CIV. CODE §2923.5.

38 CIV. CODE §2924.18(d).

39 See also CIV. CODE §2924.18(d).

40 CIV. CODE §§2923.5(a)(1)(B), 2924.18(a)(1).

41 CIV. CODE §2920.5(c).

42 CIV. CODE §§2924.15, 2924.18(f).

43 CIV. CODE §§2923.55(g), 2923.6(i).

44 CIV. CODE §2923.55(a)(2).

45 CIV. CODE §2923.55(b).

46 Id.

47 CIV. CODE §§2923.6(c), 2924.18(a)(1).

48 Id.

49 CIV. CODE §2923.6(f).

50 CIV. CODE §2923.6(e)(1).

51 CIV. CODE §2924.10.

52 CIV. CODE §2924.9.

53 CIV. CODE §2924.17(a).

54 Id.

55 CIV. CODE §§2924.17(b), 2924.17(c).

56 CIV. CODE §2924.17(c).

57 CIV. CODE §2924.17(g).

58 CIV. CODE §2923.7(a).

59 CIV. CODE §2923.7(c).

60 Id.

61 CIV. CODE §2924(a)(6). Previously, CIV. CODE §2924 stated that the “trustee, mortgagee or beneficiary, or any of their authorized agents” shall file a NOD.

62 CIV. CODE §2924(a)(5).

63 CIV. CODE §§2924.12(a)(1), 2924.19(a)(1).

64 CIV. CODE §§2924.12(b)-(c), 2924.19(b)-(c).

65 CIV. CODE §§2924.12(b), 2924.19(b).

66 CIV. CODE §§2924.12(b), 2924.19(b).

67 CIV. CODE §§2924.12(b), 2924.19(b).

68 CIV. CODE §§2924.12(b), CIV. PROC. §1161b.5

69 Id. & CIV. PROC. §415.461(b).

70 Id.

71 CIV. CODE §2923(c).

72 PENAL CODE §802(e).

73 CIV. CODE §2929.3.

74 HEALTH & SAFETY CODE §17980.


A recent Second District opinion, *Silk v. Feldman*, reaffirmed that a homeowners association (HOA) is a quasi-governmental entity. The holding essentially reiterates an earlier Fourth District opinion holding that association board meetings and the publications of HOA boards involve public issues to which anti-SLAPP statutes apply. For attorneys representing or suing HOAs, the classification of a private HOA as a quasi-governmental entity (rather than, for example, a business entity) may support claims or defenses that, while arguably warranted under existing law, could also substantiate arguments for extensions or modifications of existing law.

In *Silk*, the plaintiff, a homeowner within a common interest development, sued the defendant, a homeowner and member of the association’s board of directors, for defamation and libel. These causes of action were premised upon a letter that the defendant wrote to the association members in which he accused the plaintiff of cutting “secret deals” and “feather[ing] [her] own nest.” The defendant moved to dismiss the complaint under the anti-SLAPP statute, asserting that his publication was protected under Code of Civil Procedure Section 425.16(e) as a statement made in connection with an issue under consideration by a judicial body, as a statement made in a public forum in connection with an issue of public interest, and as “other conduct in furtherance of the right of free speech.” The trial court denied the defendant’s motion, finding that the alleged defamation was not an exercise of the right of petition or free speech.

The Second District affirmed the trial court’s denial of the defendant’s anti-SLAPP motion, but not on the ground that the alleged defamation or libel was not an exercise of the right of petition or free speech. Instead, the appellate court held that the plaintiff carried her burden of showing a probability of prevailing in the action (the second courts have consistently ruled that HOAs are legally similar to municipal governments, but questions remain about how close that similarity is
The Fourth District also concluded that the association’s newsletter was a public forum and a “vehicle for communicating a message about public matters to a large and interested community.”

**State and Federal Court Conflict**

In California, the question of whether it is appropriate to call an HOA a quasi-governmental entity appears to be adequately answered in *Damon* and *Silk*. At least one fed-
tions of an HOA included “employing a professional property management firm, obtaining insurance for the benefit of all owners, maintaining and repairing common areas, establishing and collecting assessments from all owners to pay for its undertakings, and adopting and enforcing rules and regulations.”

To buttress its holding, the *Sui* court, citing “persuasive authority” of the Ninth Circuit, concluded that none of the California cases cited by the *Sui* plaintiffs “holds or implies that a California homeowners’ association effectively exhibits ‘all of the attributes of a state-created municipality and the exercise by [the homeowners’ association] of semi-official municipal functions as a delegate of the State,’ such that the homeowners’ association ‘was performing the full spectrum of municipal powers and stood in the shoes of the State.’”

As one can see, the distinction between the *Silk-Damon* analysis and the one employed by the Central District and Supreme Court is nebulous.

**Potential Legal Implications**

Despite the apparent and recent conflict between California state courts’ willingness and the Central District’s hesitancy to endorse the quasi-governmental nature of homeowners associations, the concept does raise interesting questions. To what end can this classification be extended, or has that end already been reached? *Damon* and *Silk* certainly support the application of “public fora” and “public issue” principles to certain activities of a homeowners association in the context of a defamation action, thereby substantiating a special motion to strike under anti-SLAPP law. More broadly speaking, however, the rationale of the *Damon* and *Silk* holdings can conceivably be used to support other claims and defenses.

For example, an argument could be made that any decision of the board of directors with respect to the amendment, interpretation, or enforcement of governing documents, or to decisions related to the assessment of fines and penalties for violations of the CC&Rs, are immune from civil liability, regardless of the form of the cause of action. In essence, the board of directors, in interpreting and enforcing the provisions of its governing documents, acts similarly to a local legislature, administrative agency, or judicial body. According to *Damon* and *Silk*, an HOA board when it acts in good faith.

**Governmental Sovereign Immunity**

Perhaps the furthest, but not implausible, extension of the argument that HOAs are quasi governmental is that HOAs should enjoy the immunities of a public entity under Government Code Sections 815 et seq. Community associations are already protected from liability by judicial deference (the *Lamden* rule). Public-entity immunity is a natural extension of this concept, particularly when coupled with the quasi-governmental nature espoused in *Damon* and *Silk*.

Relevant to the determination of whether a private association is entitled to qualified immunity as a quasi-governmental entity are the association’s activities and its relationship to government. In cases in which courts have recognized a private entity’s claim of immunity, the entity had performed quasi-governmental functions pursuant to a governmental grant of authority. According to *Damon* and *Silk*, the board of directors of an HOA performs public, quasi-governmental functions. HOAs are granted statutory powers, duties, and responsibilities by Civil Code Sections 1350 et seq. and by judicial enforcement of CC&Rs. If many Californians consider their HOAs a “second municipal government, regulating many aspects of their daily lives,” and if HOAs have heightened duties paralleling those of municipal government entities, should HOAs not also enjoy the same immunities?

As this area of law continues to develop, these and other questions will likely be presented to the courts and the legislature. These questions call for analysis, and novel claims or defenses should be considered by counsel who defend or prosecute HOAs.

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6. Id. at 476.
7. Id. at 479; see also Chantiles v. Lake Forest II Master Homeowners Ass’n, 37 Cal. App. 4th 914, 922 (1995).
9. Id. at 479; see *Damon* v. Lake Forest II Master Homeowners Ass’n, 37 Cal. App. 4th 914, 922 (1995).
10. Id. at 1509 (citing Rivero v. American Fed’n of State, County and Mun. Employees, AFL-CIO, 105 Cal. App. 4th 913, 919, 926 (2003)).
14. Id. (citing O’Connor v. Village Green Owners Ass’n, 33 Cal. 3d 790, 796 (1983)).
15. O’Connor, 33 Cal. 3d at 796.
17. Id. at “16-17 (emphasis in original) (citing Hudgens v. NLRB, 424 U.S. 507, 519 (1976)).
20. Cohen v. Kite Hill Community Ass’n, 142 Cal. App. 3d 642, 651 (1983) (“The…governmental aspects of the association…give rise to a special sense of responsibility upon the officers and directors.”).
22. Id. at “12 (citing Snowden v. Preferred RV Resort Owners Ass’n, 379 Fed. Appx 636, 637 (9th Cir. 2010).
24. Lamden v. La Jolla Shores Clubdominium Homeowners Ass’n, 21 Cal. 4th 249 (1999) (Under the *Lamden* rule, a court should defer to the decisions of an HOA board when it acts in good faith.).
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Examining San Bernardino's Mortgage Condemnation Program

THE SUMMER OF 2012 brought to California not only several municipal bankruptcies but also the highly publicized formation of a Joint Powers Authority (JPA) by San Bernardino County and some of its municipalities. The JPA was created to seize and restructure certain mortgages to assist homeowners who were underwater (that is, their homes were worth less than their mortgage debt).

With the stated purpose of stimulating San Bernardino’s economy, the Homeownership Protection Program JPA was promoted by a Northern California venture capital firm. Under the program, local governments would take title to the mortgages (but not the real properties) and pay the mortgage holders “fair market value” with money provided by institutional investors. The government and investors would then issue new mortgages to the homeowners, setting the loan amount slightly below the fair market value of the home, which would enable distressed homeowners to acquire equity and reduce their monthly payments. The restructured mortgages would then be sold to third-party investors (déjà vu), with the government recovering administrative costs and the venture capital firm earning a fee on each transaction.

Underwater mortgages are a significant byproduct of the 2008 stock market crash, in which packagers of mortgage tranches were among the principal bad guys. Since 2008, approximately $7 trillion in household home equity wealth has been lost, and nearly 23 percent of the 52.5 million mortgaged homes in the United States are under water. Moreover, 14,000 homes in San Bernardino County are either already foreclosed or on the brink of foreclosure. Underwater homeowners who live in the shadow of debt overload do not spend. This drains consumer demand from the economy, worsening unemployment.

In this context it is hardly surprising that San Bernardino County is considering a mortgage condemnation program. Among its selling points: 1) only performing loans are included, 2) it is privately funded, requiring no new taxes or funding from public entities, and 3) it targets loans ensnared in private securitization trusts. The plan has the blessing of Robert Schiller, one of the economists who created the Case-Schiller Index.

Although questions have been raised as to the federal constitutionality of the JPA program, the 1984 US Supreme Court’s decision in Hawaii Housing Authority v. Midkiff—allowing the state of Hawaii to condemn properties for the purpose of selling them to individuals who owned housing on them—would appear to authorize the takings contemplated under the program proposed for San Bernardino. Less sanguine, however, is the analysis under state constitutional takings contemplated under the program proposed for San Bernardino.

With the 1982 holding of the California Supreme Court in City of Oakland v. Oakland Raiders serve as examples of the legal hurdles that the JPA faces. Furthermore, because the mortgages targeted by the program are likely held by securitization trusts located outside the enforcing public entity, Code of Civil Procedure Section 1240.050 would appear to preclude the JPA program, however well intentioned it may be.

Practical concerns have also been raised. Reliance on juries to limit compensation to fair market value in an eminent domain action is problematic at best. The impact on the housing markets affected by legislation implementing the program could lead to higher interest rates or a cessation of local real estate lending. If any of the mortgages taken are the product of a refinance instead of a purchase-money loan, the lender would have recourse against the buyer for shortages arising out in an eminent domain action. Almost all loan documents require the borrower to defend the lender in any eminent domain action, typically with the counsel of lender’s choosing. This would result in a homeowner being financially devastated by the obligation to pay the lender’s attorney’s fees. Moreover, the proposed program could be viewed as a forced write-downs of loans, which could drain some bank reserves, providing banks with a reason to refuse to make loans.

On the other hand, the public purpose in the proposed JPA program is the establishment of incentives for homeowners to remain in their houses while their loans are reconfigured. The specter of abandoned or vacant foreclosed houses, with the attendant adverse impacts on neighborhood property values, is grim. The fundamental question is, given 1) the limited resources of the government, 2) the likelihood that constitutional and other challenges to the program will be raised, and 3) the adverse effect on lender reserves, is the JPA program worth the risk? Although the JPA program presumes to be revenue neutral, the public sector is relying on the good faith performance of one of the primary bad actors of the 2008 residential property meltdown. In this context, it is better to allow regulated market forces to correct the previous excesses, even if the short-term effects are severe.

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