Los Angeles lawyer Ashley B. Jordan provides an overview of the key insurance issues in recent state and federal court decisions concerning construction defect liability.
November 17, 2014

Jack Trimmerco & Associates
Polygraph / Investigations, Inc.
9454 Wilshire Blvd., 6th Floor
Beverly Hills, CA 90212

Dear Mr. Trimmerco:

In the winter of 2010, an environmental disaster occurred off the west coast of the island of Oahu in the State of Hawaii. Heavy rainfall caused millions of gallons of contaminated water—including toxic soil, trash and human medical waste—to pour from the Waimanalo Gulch Sanitary Landfill into the ocean waters. Federal officials launched an investigation into the landfill’s operator, Waste Management of Hawaii (“WMH”). The U.S. Attorney’s Office alleged there was a conspiracy between members of the WMH and its environmental consulting firm to submit false information to regulators about the adequacy of the landfill’s storm water management system.

I represented an employee of the environmental consulting firm hired by WMH to perform construction quality assurance. During the investigation, all evidence pointed to the fact that my client was innocent of any wrongdoing. Nevertheless, the Assistant U.S. Attorney insisted that my client pass a polygraph, or else risk being indicted as a participant in the criminal conspiracy.

In 2012, you conducted a polygraph examination of my client, unequivocally establishing that no deception was indicated. The Assistant U.S. Attorney then demanded that my client pass a polygraph examination administered by FBI agents in Honolulu. The FBI alleged my client failed their polygraph examination, but you responded with a thorough and compelling critique demonstrating how the FBI’s polygraph examination was deficient and should be disregarded.

Last year, I was notified by the U.S. Attorney’s Office of the District of Hawaii that their office would not seek an indictment of my client, nor would any charges against him be pursued. I believe your carefully and competently constructed polygraph examination and critique of the FBI’s polygraph results played a central role in our advocacy that prosecution should be declined in my client’s case.

Sincerely,

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Because real estate plays a key role in our community, Los Angeles Lawyer follows its 33-year-old tradition of dedicating the first issue of the new year to matters affecting those practicing in this field. The tug of war that can occur between landlords and tenants over property rights in a bankruptcy proceeding is the focus of Gary F. Torrell’s article. In a recent case, the Ninth Circuit reconciled two seemingly contradictory provisions in the Bankruptcy Code: One statute allows tenants to remain in possession if they satisfy the lease obligations while another allows a landlord or trustee to sell property free and clear of all liens and interests, including leases. Although the court upheld the trustee’s sale of the affected land free and clear of the tenants’ leases, the tenants could have mitigated their losses had they asserted their rights to “adequate protection,” which they failed to do.

Preservation of California’s pristine beaches is covered in Angela Howe’s article on the California Supreme Court’s decision in Lynch v. California Coastal Commission. This opinion may be more significant for the issue the court did not address than the one it decided. The justices narrowly focused their unanimous opinion on actions taken by bluff-top homeowners in rejecting their objections to the Coastal Commission’s approval of a seawall. Unlike the court of appeals, the supreme court did not cover the more significant environmental issues presented by the homeowners’ challenge to the Commission’s permit conditions.

Construction and insurance law attorneys will find Ashley B. Jordan’s article to be instructive on coverage issues for latent construction defect claims arising under commercial general liability (CGL) policy terms. Jordan reviews recent federal and state decisions on whether faulty work constitutes an “occurrence” within the terms of current CGL policies, how courts have interpreted the phrase “trigger of coverage” despite the absence of this phrase in CGL policies or the Insurance Code and insurers’ response to that interpretation, and whether “business risk” or “ongoing operations” work exclusions constitute grounds for insurers to deny coverage.

Author Gary A. Meyer notes that Southern California commercial and industrial properties have frequently been used for various operations that result in these properties’ becoming contaminated with chemicals now regulated by strict environmental laws. Meyer examines the regulatory issues sellers and buyers may encounter in the purchase and sale of contaminated land, the resources available to determine the source and level of contamination, and whether any remediation has occurred. He then recommends strategies each side can follow in protecting their interests when environmental conditions arise. Landlords and tenants are also provided a similar analysis.

Finally, Rena E. Kreitenberg covers a topic potentially affecting any attorney: whether obtaining security from a client for future payment of legal fees, such as a real property lien, is voidable as a fraudulent transfer when the client subsequently files for bankruptcy. As Kreitenberg explains, attorneys can retain this security if their fee arrangements satisfy certain criteria.

Ted M. Handel is the chief executive officer of Decro Corporation, a nonprofit housing developer that develops and manages affordable multifamily projects for low-income families and seniors. Paul S. Marks is a partner with the Neufeld Marks law firm in Los Angeles. They are the coordinating editors for Los Angeles Lawyer’s special issue on real estate law and both are former chairs of the Los Angeles Lawyer Editorial Board.
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LACBA’s Immigration Legal Assistance Project Aids Dreamers

OCTOBER 5, 2017, WAS THE DEADLINE FOR DREAMERS—undocumented immigrants brought to the United States as children—to apply for work-permit renewals under the Deferred Action for Childhood Arrivals program (DACA). One demonstrator told news reporters, “[We are] fighting for our right to be human.” At the intersection of Wilshire Boulevard and Veteran Avenue in the Westwood neighborhood of Los Angeles, the demonstrator continued, “We’re here as refugees from all different parts of the world.”

An unassuming reception area lies on the third floor of the Federal Building at 300 North Los Angeles Street downtown. Children’s drawings decorate the walls. A girl from Belize drew herself on a donkey, and a boy from Egypt drew a heart. In other pictures, a girl from Italy created the American and Italian flags, and a boy from Cambodia depicted a house on stilts next to a palm tree and a dog, dark storm clouds gathering overhead. I walked into the Los Angeles County Bar Association (LACBA) Immigration Legal Assistance Project one Monday morning in September to learn ways in which new and young attorneys might contribute to the work of the project. The recent announcement by the Trump administration regarding the phaseout of DACA had directed my attention to immigration issues and the ways in which young lawyers might provide legal assistance.

Before the morning was through, I had witnessed eight consultations—eight individuals or families who had found their way to the project for immigration help. No two cases were the same, but all contained one common thread: the clients needed assistance of the Immigration Legal Assistance Project in order to receive legal services for which they had a pressing need.

When a client walks into the Immigration Legal Assistance Project (no appointment necessary), he or she pays only a $20 consultation fee. LACBA’s charitable arm, Counsel for Justice, supports the Immigration Legal Assistance Project and three others: the Domestic Violence Legal Services Project, Veterans Legal Services Project, and AIDS Legal Services Project.

The projects work together on crossover issues that arise, funneling clients to the proper places. For example, a client in need of a U visa—a nonimmigrant visa set aside for victims of crime who assist law enforcement—might seek out the Immigration Legal Assistance Project, which would ultimately direct them to the Domestic Violence Project.

2016 Statistics

In 2016, 663 volunteers (including attorneys, law students, para-legals, interpreters, and mediators) allowed LACBA’s projects to help 17,790 clients, providing $3,764,025 in pro bono legal services (over 14,975 hours of pro bono legal services).²

The Immigration Legal Assistance Project provides legal assistance and counsel to all categories of low-income persons for nominal fees. It uses its resources to 1) provide immigration legal advice for U.S. citizens, immigrants, and aliens; 2) prepare immigration and naturalization forms; 3) translate, certify, notarize, and copy documents; 4) tie in lawyer referral service and all appropriate social service agencies; and 5) train law students, attorneys, and volunteers in all aspects of immigration law and procedures.

The Immigration Legal Assistance Project relies heavily on its committed volunteers, five each day of the week. Volunteers need not have specific immigration law knowledge to volunteer for the project; however, the volunteer must commit to volunteering for at least one day per week for a 12-week period. In so doing, the Immigration Legal Assistance Project is able to train volunteers to efficiently and effectively provide pro bono immigration legal services.

On January 1, 2016, the project received a grant from the State of California to provide free legal assistance for Dreamers, either renewing or applying for DACA, as well as DACA applicants seeking advance parole, family petitions, or adjustment of status. However, on September 5, 2017, when the Department of Homeland Security initiated the orderly phaseout of DACA, it provided a limited, six-month window during which it would consider certain requests for DACA and applications for work authorization, under specific parameters.

As a result, I witnessed a consultation in which the future of one Dreamer was painfully unclear, although the Immigration Legal Assistance Project did educate her as to all alternatives she might pursue. New and young attorneys are equipped to contribute to the project and make a meaningful difference in clients’ lives.

Although not everyone could be helped as he or she desired—I feel particularly haunted by a girl who was set to lose her DACA status—when I walked out of the Immigration Legal Assistance Project, past a drawing of a flower by Lucas of France, age five, the value of this project was clear: not only are legal services rendered, but a spirit of hope and safety also pervade within those walls—it is a place in which we all can feel human.

To find out more about the project or to volunteer, please visit the project’s website (https://www.lacba.org/give-back/immigration-legal-assistance-project/immigration-legal-assistance-project-volunteer-form) or contact Project Director Mary Mucha at (213) 485-0143 or mmucha@lacba.org.

Victoria M. McLaughlin is an attorney at the Law Offices of William E. Crockett. She is the vice president of the LACBA Barristers Section and sits on the board of governors of the Women Lawyers Association of Los Angeles.


² This is waived in some cases.


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Owner vs. Tenant Rights in a Property in Bankruptcy

RENTERAL PROPERTY OWNERS IN BANKRUPTCY and bankruptcy trustees want to sell properties free of leases to maximize sale proceeds. Tenants, however, want bankrupt landlords to honor the leases to avoid disrupting, if not terminating, their businesses. On its face, the U.S. Bankruptcy Code seems to take two contradictory approaches to reconciling these conflicting interests. One code provision says tenants of bankrupt owners can stay in possession for the term of their lease if they pay rent when due and honor other lease terms. However, another provision allows a bankrupt owner or trustee to sell property free and clear of all liens and interests. Many bankruptcy courts interpret the latter statute to allow a tenant’s leasehold interest to be extinguished in approving a sale.

The U.S. Court of Appeals for the Ninth Circuit recently interpreted these statutes to determine if a conflict truly existed between them. This decision involved related debtors, the primary being Spanish Peaks Holdings, LLC, which owned Big Sky Resort, a 5,700-acre property in Big Sky, Montana. James J. Dolan ran Spanish Peaks Holdings, and Spanish Peaks Holdings signed two long-term leases with related company tenants at monthly rents below market. Dolan also was an officer of both tenants and signed the leases for both the landlord and two tenants. The Ninth Circuit ruled the chapter 7 trustee could sell the real property free and clear of the lease interests over the tenants’ objections.

As developer of the resort property, Dolan planned to build a ski and golf resort, restaurant, and other facilities. One lease, for restaurant space, was made in 2006 between Spanish Peaks Holdings as landlord and Spanish Peaks Development, LLC, with rent charged at $1,000 per month. A year later, the parties replaced the lease with a new version between Spanish Peaks Holdings and an entity called the Pinnacle Restaurant at Big Sky, LLC (Pinnacle), a company that Dolan controlled, for a term of 99 years and with the rent reduced to $1,000 per year. The resort’s general manager later told the bankruptcy court he had negotiated numerous leases and that he believed a fair market rent for the restaurant was $40,000 to $100,000 per year. Dolan also signed a 60-year lease with Montana Opticom, LLC (Opticom), of which he was the sole officer, for three cellphone tower locations, with the rent being only $1,285 per year.

In October 2011, facing multiple lawsuits and unable to sell the resort, Spanish Peaks Holdings and two related companies also controlled by Dolan—The Club at Spanish Peaks, which managed the resort facilities, and Spanish Peaks Lodge, LLC, which managed real estate sales—filed chapter 7 bankruptcy in Delaware. The cases were consolidated a few months later and, at the request of certain parties, the Delaware court transferred the cases to the bankruptcy court in Montana. The bankruptcy court appointed a trustee that, with the agreement of the senior lender holding a mortgage totaling more than $122 million, retained a real estate agent to find qualified buyers for the resort.

The trustee prepared a term sheet for the proposed sale, which provided that, “Pursuant to Section 363(f) of the Bankruptcy Code, all of the Debtors’ right, title and interest in and to the Property will be transferred free and clear of all liens, claims, encumbrances and other interests in the Property,” other than some permitted encumbrances. In addition, it said, “Any other perfected, enforceable, valid liens, claims, interests and encumbrances (if any) will be discharged by the order approving the sale.”

The bankruptcy court commented that “[t]hroughout the sales process, the Trustee did not give a lot of thought” to the restaurant and cell tower leases, because the trustee’s financial advisor felt “the status of the Leases” made them immaterial to the sale.

In response to the auction sale, Pinnacle and Opticom (along with Spanish Peaks Holdings acting for the tenants) asked the bankruptcy court to affirm that they “could avail themselves, by separate motion, to any rights they might have under 11 U.S.C. § 365(h)” to remain in possession of the leased properties. The court denied their motion without explanation. The trustee then filed a motion rejecting the restaurant and cell tower leases because “the estate no longer possesses the property that is the subject of the Leases.” The debtor and two tenants did not respond, and the court granted the motion.

By failing to respond, the tenants made a critical mistake because they did not exercise their right under Bankruptcy Code Section 363 to request “adequate protection” of their leasehold interests in connection with (and prior to the court’s approval of), the sale of the resort. After the bankruptcy court approved the sale, the court conducted a hearing on what rights, if any, the two tenants retained. The court applied what it called a “case-by-case, fact-intensive, totality of the circumstances, approach,” and relied on several factors in making its determination on these rights. First, the restaurant tenant had not operated the restaurant for over six years. Second, the rent was far below fair market. Third, the leases were signed at a time when the landlord and both tenants were controlled by the same person. Fourth, the leases were subject to a bona fide dispute. Finally, under state law if the bank with a lien on the property foreclosed, it would wipe out the leases (created after the bank’s lien), and the trustee could use such state law in bankruptcy to avoid the leases when selling the property.

Based upon these findings, the bankruptcy court ruled the sale could proceed free and clear of the leases. The U.S. District Court affirmed the bankruptcy judge’s rulings and this decision was appealed to the Ninth Circuit.

Gary F. Torrell is a partner at Valensi Rose, PLC, where he leads the firm’s Business and Finance, Real Estate, and Creditors’ Rights practice groups.
The appellate court acknowledged the potential tension between Bankruptcy Code Section 363, which authorizes a trustee to sell property free and clear of all liens and interests, and Section 365(h) which supposedly protects a tenant when a bankrupt landlord “rejects” the lease and gives the tenant an option to remain in possession of the leased premises for the balance of the lease term.

The Ninth Circuit noted a “majority” of courts, when trying to reconcile the apparent conflict between these two statutes, ruled a tenant’s rights under Section 365 supersede those conferred on a trustee or debtor under Section 363 to sell property free and clear of leases. The appellate court stated “several bankruptcy courts have held that sections 363 and 365 conflict when they overlap,” because “each provision seems to provide an exclusive right that when invoked would override the interest of the other.”

The Ninth Circuit judges also commented that several courts that have decided the issue have applied “the canon of statutory construction that ‘the specific prevails over the general’” and, thus, Section 365 takes precedence over Section 363. In addition, the majority reasoned that “the legislative history regarding section 365 evinces a clear intent on the part of Congress to protect a tenant’s estate when the landlord files bankruptcy.”

Despite these precedents, the Ninth Circuit decided to follow a different legal analysis from the U.S. Court of Appeals for the Seventh Circuit, which ruled in Precision Industries, Inc. v. Qualitech Steel SBQ, LLC, that Sections 363 and 365 “themselves do not suggest that one supersedes or limits the other.” Section 363, the Seventh Circuit reasoned, confers a right to sell property free and clear of “any interest,” including leases entitled to protections under Section 365. In contrast, it noted that Section 365 has a more “limited scope.” Specifically, Section 365(h) “focuses on a specific type of event—the rejection of an executory contract by the trustee or debtor-in-possession—and spells out the rights of parties affected by that event. It says nothing about sales of estate property, which are the province of section 363.”

As the Seventh Circuit pointed out, Section 363(e) entitles tenants to seek “adequate protection,” in connection with a sale of the underlying property. This means tenants “are therefore not without recourse in the event of a sale free and clear of their interests,” because they have the right to seek protection under Section 363(e), and if they do so, “the bankruptcy court is obligated to ensure that their interests are adequately protected.”

If the property is not sold and the trustee or debtor (acting for the bankruptcy estate) retains ownership but chooses to reject the lease, Section 365(h) gives the tenant the right to remain in possession under the terms of its lease. Understood this way, the Seventh Circuit said, “both provisions may be given full effect without coming into conflict with one another and without disregarding the rights of lessees.”

The Ninth Circuit noted that even with the analysis provided by the Seventh Circuit, a significant issue remains; that is, whether a trustee has “rejected” the lease. The Ninth Circuit acknowledged that the Bankruptcy Code does not define a “rejection,” but said the term “is universally understood as an affirmative declaration by the trustee that the estate will not take on the obligations of a lease or contract made by the debtor.”

A sale of property free and clear of a lease “may be an effective rejection of the lease in some everyday sense,” but it is “not the same thing as the ‘rejection’ contemplated by section 365.”

The Ninth Circuit’s interpretation of the statutes was that “section 363 governs the sale of estate property, while section 365 governs the formal rejection of a lease. Where there is a sale, but no rejection (or
a rejection, but no sale), there is no conflict.” However, circumstances exist when a trustee’s failure to act would be considered a rejection. For example, failing to assume or reject a residential lease within 60 days in a chapter 7 liquidation, or within 120 days for a nonresidential lease if the debtor is the lessee, is deemed to be a rejection.23 However, in In re Spanish Peaks Holdings II, LLC, all parties agreed the restaurant and cell tower leases were not formally rejected prior to sale of the underlying real property. Because no leases had been formally rejected, the Ninth Circuit reasoned that Section 365 was not triggered.26

In addition to the Seventh Circuit’s analysis of the statutory language, the Ninth Circuit identified other reasons why Sections 363 and 365 do not necessarily conflict: “First, we note the mandatory language of section 363(e). A bankruptcy court must provide adequate protection for an interest that will be terminated by a sale if the holder of the interest requests it.”27 The term “adequate protection” can include any relief (other than compensation as an administrative expense) that will “result in the realization by such entity of the indubitable equivalent” of the interest that will be terminated.28

Because the tenants in Spanish Peaks failed to request adequate protection before the property was sold, the Ninth Circuit was not required to decide what “adequate protection” the bankruptcy court could or should have awarded to them. “Still,” the Ninth Circuit said, “we think it worth mentioning that the broad definition of adequate protection makes it a powerful check on potential abuses of free-and-clear sales.”29 In addition, the Ninth Circuit said, “[We] emphasize that section 363(f)(1) “refers not to foreclosure sales, but rather only to situations where the owner of the asset may, under nonbankruptcy law, sell an asset free and clear of an interest in such asset.”30 The Ninth Circuit said that Section 365 recognizes rights conferred by a lease “to the extent that such rights are enforceable under applicable nonbankruptcy law,” which would include the law governing foreclosure sales. The court concluded that the “clear intent” of the statute is “to protect lessees’ rights outside of bankruptcy, not an intent to enhance them.”31

The Ninth Circuit noted that its analysis “highlights a limitation inherent in the ‘majority’ approach taken by other courts.”32 Section 365 reflects the intent of Congress to protect lessees. “But that intent is not absolute; it exists alongside other purposes and sometimes conflicts with them,” the court said.33 In some circumstances, protecting a lessee can reduce the value of the estate if the terms of a lease favorable to that lessee makes the property less desirable to a buyer. That would be contrary to the goal of “maximizing creditor recovery,” which is a key objective of the Bankruptcy Code, it noted.34 “The statutory text is the best assurance we have that we are balancing competing purposes in the way Congress intended,” it added.35

For tenants of a bankrupt landlord, the lesson to be learned here is to aggressively pursue and protect one’s rights and request “adequate protection” under Bankruptcy Code Section 363 when any sale of the underlying real property is proposed free and clear of the tenant’s lease. (Most bankruptcy sales are structured to offer the property free and clear of leases and thereby increase the sale proceeds. These “sold out” tenants may file a claim for damages, but the recovery can be little and worth far less than the right to continue using the rental property. Tenants facing these circumstances should consult with experienced bankruptcy counsel and discuss various forms of “adequate protection” they should request as a condition to a court’s approval of a trustee (or chapter 11 debtor’s) request to sell property free and clear of the tenant leases.)

Id. at 21.
Id.
Id. at 1152.
Id. at 1153.
Id.
Id. at 1151.
Pinnacle Rest., 862 F. 3d at 1155 (quoting In re Taylor, 198 B.R. at 165).
Precision Ind., Inc. v. Qualitech Steel SBQ, LLC (In re Qualitech Steel Corp. & Qualitech Steel Holdings Corp.), 327 F. 3d 537, 547 (7th Cir. 2003).
Id.
Id.
Pinnacle Rest., 862 F. 3d at 1155 (quoting Precision Ind., 327 F. at 548).
Pinnacle Rest., 862 F. 3d at 1155-56.
Id. at 1156.
Id.
Id.
Pinnacle Rest., 862 F. 3d at 1157.
Pinnacle Rest., 862 F. 3d at 1156.
Id.
Id.
Id.
Id. at 1157.
Id. at 1156.
Id. at 1157.
Pinnacle Rest., 862 F. 3d at 1157.
Id.
Id.
Id.
Id.
17 Precision Ind., Inc. v. Qualitech Steel SBQ, LLC (In re Qualitech Steel Corp. & Qualitech Steel Holdings Corp.), 327 F. 3d 537, 547 (7th Cir. 2003).
Id.
Id.
Id.
Id.
Id.
26 8 Pinnacle Rest., 862 F. 3d at 1153.
27 Pinnacle Rest., 862 F. 3d at 1156.
29 Pinnacle Rest., 862 F. 3d at 1156.
30 Id.
31 Id.
32 Id. at 1157.
33 Id. at 1156.
34 Id. at 1157.
36 Pinnacle Rest., 862 F. 3d at 1157.
37 Id.
38 Id.
39 Id.
40 Id.
ENCINITAS IS A HIP LITTLE BEACH TOWN in North County San Diego, home to beautiful beaches, crowded coffee shops, and all the charms of coastal living. Unfortunately, it is also home to controversy surrounding the very asset that defines it: the coastline. The sandy beach in Encinitas is disappearing due to erosion and rising sea levels. In the face of rising seas, natural coastlines would normally migrate inland and use sand from bluff resources to restore the beach; however, a hardened structure, e.g., a wall that is intended to stabilize a bluff or protect it from oncoming waves, essentially fixes the back of the beach in a certain spot thus disrupting the natural shoreline processes. Expert geologists warn that dry beach width is consistently and significantly narrower where a wall or hardened structure exists. Because sandy beaches are being enveloped with water from the seaward side, while also being deprived of sand from the landward side, seawalls ultimately force the shoreline to migrate inland, reducing the width of the beach in front of the seawall and eventually leading to total loss of the sandy beach. A rise in sea level also exacerbates this process.

Bluff stabilization seawalls remain a primary means of protecting existing structures situated on an eroding coastline. Local municipalities and the California Coastal Commission have been addressing the issue of seawalls and other forms of coastal armoring or reinforcement through Local Coastal Programs (LCPs) and guidance documents. These entities also must decide on individual permits for coastal armoring projects and incorporate thoughtful coastal management provisions in this permitting process.

Lynch Seawall Case

Encinitas homeowners and neighbors Barbara Lynch and Thomas Frick own adjacent properties that sit on a bluff and cascade steeply down to the beach and shoreline. These bluff-top homeowners share a seawall and a private staircase. The 100-foot long seawall was meant to stabilize the bluff upon which the homes are built, and the staircase provides private access to the beach. The seawall and staircase both have a long history of regulation by the Coastal Commission. The original staircase was constructed prior to enactment of the California Coastal Act of 1976. When the staircase collapsed in 1973, the Coastal Commission (established by Proposition 20 and the California Coastal Zone Conservation Act of 1972) determined that reconstruction was exempt from state permitting requirements. The seawall and a mid-bluff retention structure were built in 1986, and in 1989, the Coastal Commission issued a coastal development permit (CDP) allowing the structures to remain in place. The original seawall structure was comprised of 20-foot wooden poles embedded in the sandy beach and cabled to the bluff with railroad ties anchoring the mid-bluff structure. In 2003, the bluff-top homeowners applied for a CDP with the City of Encinitas to replace the wooden erosion control structure with a textured concrete seawall system and remove and replace the lower section of the staircase.

Six years later, in 2009, the City of Encinitas approved the project based on a finding that it would not adversely affect the city’s general plan or its municipal code. However, the city conditioned its approval on the bluff-top homeowners obtaining a final permit from the Coastal Commission. The commission approved the permit but imposed the following conditions: 1) the private staircase could not be reconstructed, 2) the seawall permit would expire 20 years from the date of approval, and 3) prior to the 20-year expiration period, the owners would have to submit an application for another CDP to remove, change, or extend the seawall. The CDP also required that Lynch and Frick
record a deed restriction evidencing their agreement with the permit conditions. The bluff-top homeowners recorded the deed restrictions, which acknowledged that the special conditions of the permit were binding and restrictive covenants thus limiting their use and enjoyment of the properties. The CDP was then issued and construction began on the seawall. Meanwhile, Lynch and Frick also sued the Coastal Commission seeking a writ of mandate directing the commission to remove the conditions from the CDP. They challenged the commission’s conditions arguing that there could be no 20-year “sunset clause” or expiration date on the seawall permit, nor could the commission deny a permit to repair the staircase. Further, the bluff-top homeowners argued the new technology used in rebuilding the seawall was expected to last for 75 years. In addition, they argued that the permit term limit constituted an unconstitutional taking under the U.S. Supreme Court’s holdings in Nollan v. California Coastal Commission and Dolan v. City of Tigard. They used this case law and its progeny to argue that a government agency that imposes permit conditions without any “nexus” and “rough proportionality” to the impact of the proposed project is constitutionally impermissible.

In response to the staircase issue, the Coastal Commission argued that the city’s LCP prohibited construction of private stairways on a bluff, thus, the staircase constituted a structural nonconformity. The stairway would have to be removed or turned into a public access way. The commission cited Encinitas Municipal Code Section 30.76.50, which only allows for repair and maintenance of a structural nonconformity, not replacement. It then argued that the exemption for natural disasters under Municipal Code Section 30.80.050 did not apply for replacement of a structure destroyed by an act of God. The commission’s staff report stated that the staircase’s collapse was deemed not to be caused by a natural disaster and further found that even if it was a natural disaster, the staircase was still impermissible since the construction had to comply with the LCP and become a public stairway if it continued to exist.

**Life of a Seawall**

With regard to the seawall, the Coastal Commission argued the 20-year permit term was necessary to ensure the seawall remained safe in light of sand erosion, bluff changes, and rising sea levels that might undercut the support system after such a long period of time. Generally, this period corresponds to what coastal engineers assume for the life of a seawall. In addition, the National Oceanic and Atmospheric Administration makes boundary determinations for the mean high tide line every 18.6 years, which is used by the California State Lands Commission. If the seawall were located below the mean high tide line, it could end up on public property or affect public property. The commission also cited the collapse of the old seawall after 20 years as a rationale for this time frame. Essentially, the coastal managers wanted the opportunity to reexamine the seawall’s effects on the coastline after two decades in order to note the new location and potentially impose additional mitigation measures.

In March 2013, San Diego County Superior Court Judge Earl H. Maas III issued the writ of mandamus sought by Lynch and Frick and directed the commission to remove these conditions. Judge Maas held the staircase simply needed repair rather than replacement. The court also found the LCP’s prohibition on these structures did not apply because it refers only to new structures as private access ways and not existing structures. Further, the court sided with the bluff-top homeowners stating the Coastal Commission would retain the power to force repair or change if the seawall ever became unsafe so the agency’s concerns could be addressed without the “sunset clause.” Finally, the lower court did not directly speak to the takings claim.

**Rulings on Appeal**

Since the seawall permitting issue is central to the Coastal Commission’s authority to manage the coast in the face of rising sea level, the agency appealed the decision. The California Court of Appeal, Fourth District, reversed Judge Maas’s decision. The appellate court addressed whether 1) the permit conditions were waived by the bluff-top homeowners’ actions in signing and recording documents, agreeing to the stated conditions and then accepting the benefit of the permit by completing their project, and 2) the Coastal Commission’s conditions were valid and supported by substantial evidence. The appellate court held that Lynch and Frick waived their right to challenge the permit conditions by accepting the benefits of the permit and then went on to rule on the validity of those permit conditions. With a split decision at the appellate court in the commission’s favor, the issue generated numerous amicus briefs, including coastal property owner groups, planning and realtor associations, and coastal protection organizations. For instance, the Surfrider Foundation described the science behind how seawalls cause gradual elimination of the sandy beach and the detrimental impacts of coastalarming to the public trust resources located at the intertidal zone.

**Waiver Issue**

The California Supreme Court affirmed the appellate court on the waiver issue but declined to address the issue related to validity of the permits. Writing for a unanimous court, Justice Carol A. Corrigan concluded the bluff-top homeowners forfeited their right to challenge the permit conditions when they accepted the permit and proceeded to build the seawall authorized by the commission.

The court asked why a property owner should be allowed to accept the benefits of a permit (i.e., the right to build a seawall) without accepting its burdens (i.e., the 20-year duration). The bluff-top homeowners argued these conditions were severable and that California Civil Code section 1094.5 allows this type of relief; however, no case law exists on this issue. If the court ruled acceptance of the permit allowances did, in fact, include simultaneous acceptance of the permit conditions, the bluff-top homeowners would have waived their right to pursue a substantive challenge to the permit conditions under the Coastal Act and on constitutional grounds. Citing Pfeiffer v. City of La Mesa on this issue: “If every owner who disagrees with the conditions of a permit could unilaterally decide to comply with them under protest, do the work, and file an action…complete chaos would result in the administration of this important aspect of municipal affairs.”

According to the California Supreme Court, if the condition was invalidated after the seawall was built, the Coastal Commission could not require alternative mitigation measures such as directing the seawall be located farther inland “to account for sand loss beyond 20 years” or altering its size or design. As a matter of equity, the bluff-top homeowners should have negotiated or challenged the Coastal Commission’s conditions before proceeding with construction. After all, the court stated, “[t]he landowner is in the best position to know how strongly he objects to a particular condition.” Generally, a property owner may object to an allegedly unreasonable permit condition by refusing to comply with the condition and challenging the entire permit. This rule stems from the equitable maxim of jurisprudence, “He who takes the benefit must bear the burden.”

By ruling on the waiver issue, the state supreme court issued a decision in favor
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of the Coastal Commission and rejected the bluff-top homeowners’ claim that permit conditions imposed by the commission triggered a regulatory taking of their private property.14 As for the merits of the Coastal Commission permit, the supreme court decided: “We granted review. Because we determine plaintiffs’ claims have been forfeited, we do not decide the legality of the challenged conditions.”15

One may wonder why the bluff-top homeowners did not contend that they had an immediate need to build their seawall because of the existence of an emergency. In arguing before the supreme court, the bluff-top homeowners’ counsel took pains to avoid arguing an “emergency” condition for the seawall, knowing that this argument would lead to the rebuttal that the homeowners should have applied for an emergency permit versus the full Coastal Development Permit.16 While the California Court of Appeal decision may lack precedential value, it nevertheless provides insights and guidance on the permit conditions issue and others that will eventually need to be recognized and addressed by the California Supreme Court. Further, published authority already exists to support the Coastal Commission’s authority to mitigate the impact of seawalls.17

**Duration of the Permit**

Lynch and Frick argued the conditions limiting the duration of the permit to 20 years were invalid because they had no nexus to the seawall’s impacts and the commission had no other authority to impose them. The commission responded that the bluff-top homeowners waived any challenges to the conditions by accepting the benefits of the permit and building the seawall and that the conditions were valid and supported by substantial evidence. On this issue, the appellate court found the 20-year term was reasonable because, in part, “the seawall will likely need augmentation, replacement, or substantial changes within 20 years because of sea level rise and the seawall’s location in a high hazard area.”18

The court concluded that:

Since the Commission imposed the conditions limiting the permit’s duration to ensure the seawall’s long-term impacts do not extend beyond the time period for which the seawall’s existence can be reasonably justified to protect respondents’ existing homes, we conclude the conditions fell within the Commission’s discretion and were valid.19

Lynch and Frick also argued there should be an “under protest” exception for permit applicants who oppose non-fee conditions. The appellate court rejected this for several reasons: 1) this type of exception would effectively swallow the general rule since many permittees are asked to accept permit conditions that they consider unfavorable in order to obtain permit approval for the overall project, 2) allowing challenges of the burdens of a permit while accepting the benefits would foster litigation and create uncertainty in land use planning, and 3) a non-fee provision that would be deemed invalid is not easily quantified or remedied by the permitting agency after the fact when other comparable remedies may not be available anymore.20

Finally, with regard to the deed restrictions constituting covenants running with the land, the court stated, “Absent clear, supporting authority, we are unwilling to condone deliberate subterfuge in recorded documents as doing so would subvert the documents’ noticing function.”21

Here, the subterfuge would have been the bluff-top homeowners’ accepting the deed restrictions by recording them and then subsequently challenging the validity of these restrictions in court.

A definitive California Supreme Court decision on the permit condition issue would have provided guidance not only to the Coastal Commission but also other local municipalities in developing and enforcing LCPs. Specifically, it would have enabled the latter to be able to reconcile private property rights with protection of the public trust resources in the face of rising sea levels and adopting needed adaptation strategies. For the time being, California courts agree that property owners can either receive a permit and proceed to build a project or file suit to challenge a permit decision, but they cannot do both.

**Long-Term Effects**

The Coastal Commission imposed the contested 20-year permit term in preparation for the anticipated long-term effects of intensifying coastal storms and projected rising sea levels on the California coast. An effective rising sea level adaptation policy allows for flexible land use decisions in light of the changing shoreline environment and increased knowledge about the on-the-ground projected impacts of climate change.22 For the 20-year permit term, the court of appeal found it reasonable because, in part, “the seawall will likely need augmentation, replacement, or substantial changes within 20 years because of sea level rise and the seawall’s location in a high hazard area.”23 Since the commission imposed the conditions limiting the permit’s duration to ensure the seawall’s long-term impacts do not extend unreasonably, the court of appeal concluded the conditions fell within the commission’s discretion and thus were valid.24 The commission relied on the Ocean Harbor House case to defend its discretion to adopt measures that provide for mitigation of all significant impacts that a seawall project might have.25

**The Stairway**

The Coastal Commission argued that this would be the fourth time the stairway would have to be rebuilt. Since this type of construction is harmful to the bluff, the commission decided to deny it. As the Coastal Commission points out, the city’s coastal bluff overlay regulations, which are also part of the city’s LCP, effectively implement these policies by allowing only public access facilities on coastal bluffs.26 Because the reconstruction of the lower stairway was inconsistent with both the general plan policies and the coastal bluff overlay regulations, the court of appeal agreed that permit condition disallowing the stairwell was valid.27 The state supreme court, however, declined to address the substantive issue of the stairway modification and whether the Coastal Commission could impose this permit condition.

The California Supreme Court’s opportunity to weigh in on coastal management issues in the face of rising sea levels came and went as quickly as an ocean wave. The court passed on an opportunity to affirm or deny the policies and decisions of the Coastal Commission as well as municipalities and their LCPs while they are attempting to deal with the impact of rising sea levels and climate change on existing residential structures and other forms of coastal development that mark the California coast.

This proliferation of coastal development and threat to beach access and other coastal resources is one reason Proposition 20 and the California Coastal Act were adopted decades ago and why a strong coastal policy to protect and manage those resources is needed now more than ever. Controversies like the one over the Lynch and Frick seawall in Encinitas will only become more prevalent. Hopefully, with the next go-round in seawall litigation, coastal property owners and the beach-going public will be afforded more certainty about coastal armoring policy and the future of one of California’s most beloved assets: the beach.

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1 Molly L. Melius & Margaret R. Caldwell, *2015 California Coastal Armoring Report: Managing Coastal Armoring and Climate Change Adaptation in the 21st*
2 Melius, supra note 1, at 8.
3 As sea levels rise, the current elevation beach will be swallowed by the higher ocean water. Sandy beaches that are not constantly nourished and cannot migrate inland because of a seawall will eventually be squeezed out and lost between the rising tides and the inland backstop of coastal armoring. CALIFORNIA COASTAL COMMISSION STATEWIDE SEA LEVEL RISE VULNERABILITY ASSESSMENT (Dec. 31, 2016), available at https://documents.coastal.ca.gov/assets/climate/slr/vulnerability/FINAL_Statewide_Report.pdf.
4 PUB. RES. CODE §§30000 et seq.
8 Nollan and Dolan constitute two seminal cases in takings jurisprudence. In Nollan, a case involving a development permit for a beachfront house in Ventura, California, the U.S. Supreme Court established that a government agency can require an easement as a condition for a permit, if that exaction substantially advanced the government interest that was affected by the granting of the permit. In Dolan, a case involving a store expansion in Oregon, the regulatory takings doctrine was further refined with the holding that there must be “rough proportionality” between the city’s public interest and the proposed infringement on the property owner’s rights.
or not insurance will provide a defense and indemnity in a construction defect lawsuit presents one of the more complicated legal questions faced by insurance and construction law practitioners alike. The coverage issues are highly fact-dependent, the contract clauses vary from construction project to construction project, and the law is constantly in a state of flux. Moreover, add to these factors cases in which discovery of the defects only takes place several years after project completion—so-called “latent defects”—and the coverage question becomes even more complex. Fortunately, recent California state and federal decisions have addressed and informed several key coverage issues in the context of commercial general liability (CGL) policies, viz., whether faulty work constitutes an “occurrence,” the “trigger” of coverage, and the applicability of several standard business risk exclusions.

The insuring agreements of post-1986 CGL policy forms promulgated by the Insurance Services Office (ISO) provide that, in order for “bodily injury” or “property damage” to be covered, the harm must be caused by an “occurrence.” CGL policies define “occurrence” as “an accident, including continuous or repeated exposure to substantially the same general harmful conditions.” Carriers and policyholders often dispute whether faulty construction work qualifies as an occurrence under CGL policies because the California Supreme Court has yet to squarely address the question.

The two principal areas of contention are as follows: 1) whether the event giving rise to the loss was “accidental”—itself an undefined term in the policies, and 2) whether the type of damage sustained is covered (i.e., is there only damage to the insured’s work or is there economic loss?). There is much confusion in California jurisprudence on the former question. Some courts have interpreted the term “accident” to encompass unintended property damage resulting from intended but negligently performed acts. Others, however, have applied a narrow definition, focusing on the insured’s conduct rather than any unintended consequences.

Recent Cases
For example, Navigators Specialty Insurance Company v. Moorefield Construction, Inc. involved a suit by an insurer seeking a declaration it had no duty to defend or indemnify its insured in a construction

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defect lawsuit. The property owner sued Moorefield, the general contractor for the building, claiming the flooring had failed due to faulty construction. Navigators defended Moorefield in that lawsuit, subject to a reservation of rights; the case ultimately settled with a policy limits payment by the insurer.

Navigators then sought reimbursement from the contractor, arguing the damage to the flooring did not qualify as an occurrence under the CGL policies because it was not the result of an accident. The policies contained the standard ISO definition of occurrence.6 The trial court entered judgment in Navigators’ favor and required Moorefield to reimburse Navigators its settlement payment. The trial court found there was no occurrence because Moorefield directed the flooring subcontractor to install the flooring, despite knowing that moisture vapor emission from the concrete slab exceeded specifications. In other words, this was not an accident. Rather, it was the result of intentional conduct. Moorefield appealed.

The appellate court affirmed, determining Navigators had no duty to indemnify because the flooring failure did not constitute an occurrence, since there was no accident: “Under California law, the word ‘accident’...refers to the conduct of the insured for which liability is sought to be imposed on the insured...; where the insured intended all of the acts that resulted in the victim’s injury, the event may not be deemed an ‘accident’ merely because the insured did not intend to cause injury.”7

It was undisputed that Moorefield directed its subcontractor to install the flooring on the concrete slab. The evidence at trial also established that the subcontractor and the insured knew tests had shown the moisture vapor emission rate from the concrete slab exceeded specifications. Further, Moorefield’s project manager discussed the moisture vapor emission rate results with the developer and owner, and the decision was made, based on a cost-benefit analysis, to install the flooring. Indeed, the subcontractor performing the work anticipated problems from the high moisture levels and refused to install the flooring unless Moorefield first released it from warranty claims. The trial court found the flooring failed due to excessive concrete slab moisture present during the original construction. The court concluded the insured’s deliberate act produced the damage. There was no accident and thus no occurrence.

Notwithstanding the moisture test results, the insured and its project manager believed there was little or no risk to installing the flooring. The court stated that even if true, they ended up being mistaken, and “[a]n insured’s mistake of fact or law does not transform an intentional act into an accident.”8 The court continued:

Navigators proved that Moorefield knew about and intended to perform defective work with the hope or mistaken belief the defect would not cause property damage. Although there was no evidence that Moorefield intended to cause property damage, under California law, [the insured’s] subjective intent is irrelevant.9

The lesson of Navigators v. Moorefield is that knowledge of potential defects plus intent to perform the work is unlikely to equal an “accidental” occurrence. However, what if the contractor had not known in advance about the moisture tests and had not instructed the subcontractor to perform the defective work? Could coverage have been required under that hypothetical, since the harm was caused by an accident?

The California Supreme Court may soon provide further guidance on this question. In October 2016, the court granted the Ninth Circuit’s request for certification of the following question of California law: “Whether there is an ‘occurrence’ under an employer’s [CGL] policy when an injured third party brings claims against the employer for the negligent hiring, retention, and supervision of the employee who intentionally injured the third party.”10

The case, Liberty Surplus Insurance Corporation v. Ledesma & Meyer Construction Company, Inc.,11 is fully briefed and awaiting oral argument before the California Supreme Court.

In Liberty Surplus, the contractor (L&M) performed construction work at a middle school. Sadly, an L&M employee allegedly committed sexual acts against a student at the school. L&M’s carriers sued for a declaration that they had no duty to defend or indemnify with respect to the underlying action, and were entitled to reimbursement of the fees and costs expended to defend the underlying lawsuit. The CGL policy contained the standard ISO definition of “occurrence.”12

The parties filed cross-motions for summary judgment. The district court granted the insurers’ motion, determining L&M was obligated to reimburse its carriers for fees and costs expended to defend L&M. The court reasoned the alleged injuries were not caused by an occurrence: L&M’s alleged negligent hiring, retention and supervision were acts antecedent to the sexual molestation that caused injury to [the claimant]. While they set in motion and created the potential for injury, they were too attenuated from the injury-causing conduct committed by [the insured’s employee]. Moreover, even if one argued that L&M’s conduct of supervision and retention were not antecedent, but rather simultaneous, to the molestation...the supervision and retention are still not the injury-causing acts.13

The court also noted that “courts have rejected the argument that the insured’s intentional acts of hiring, supervising, and retaining are accidents, simply because the insured did not intend for the injury to occur.”14

L&M appealed. The Ninth Circuit certified the question outlined above to the California Supreme Court, noting the issue was an unsettled matter of insurance law in California. The Ninth Circuit declared that “resolution of this question will extend beyond the employment context, affecting many insured entities and persons,” and “[g]iven the ubiquity of insurance policies that cover ‘occurrences’ in California, this certified question presents an issue of significant precedential and public policy importance.”15 Oral argument and a decision on this important issue are expected sometime in 2018.

Trigger of Coverage

Another common dispute between policyholders and insurers is the thorny question of “trigger of coverage.” The term “trigger” is neither found in CGL policies nor defined by the California Insurance Code. Trigger of coverage refers to “that which, under the specific terms of an insurance policy, must happen in the policy period in order for the potential of coverage to arise.”16 When property damage happens over an extended period of time (i.e., due to a latent defect), the question becomes which policy or policies will respond? Will it be those in effect at the time of construction, the time the defect first manifested itself, the time the resulting damages to the structure occurred, or some other time?

The insuring agreement of 1986 and later ISO occurrence-based policies states as follows: “The insurance applies only to ‘bodily injury’ and ‘property damage’ which occurs during the policy period.”17 California law thus holds that occurrence-based CGL policies are “triggered” at the time the damage takes place.18

The California Supreme Court laid the foundation for this principle in Montrose Chemical Corporation v. Admiral Insur-
The injury to the wood resulting from the initial causal event,...may have constituted a further causal event in the chain between Tidwell’s negligent installation and the fire.

controlling; “It is only the effect—the occurrence of bodily injury or property damage during the policy period...—that triggers potential liability coverage.”20

Montrose, however, left some questions unanswered. The court in Tidwell Enterprises, Inc., et al. v. Financial Pacific Insurance Company, Inc.21 recently addressed the trigger issue in the latent construction defect context. The insurer, Financial Pacific, refused to defend its insured, Tidwell, against a construction defect action under a series of CGL policies.22 Tidwell had installed a fireplace system in a home that was later damaged by fire. Tidwell sued Financial Pacific, alleging the carrier owed it a defense.

Financial Pacific moved for summary judgment on the coverage issue. The trial court granted the carrier’s motion, reasoning the fire occurred after the expiration of the last Financial Pacific policy. The appellate court reversed, concluding there was a possibility the damages were covered, as they may have been caused by physical injury to the house predating the fire. It explained the allegations and known facts indicated as follows:

Tidwell might have negligently installed a custom top on the chimney in the [ ] house that restricted the flow of air in the chimney, which in turn might have resulted in excessive heat in the chimney every time a fire was burned in the fireplace from the time the house was built, which in turn (through the process of pyrolysis) might have altered the chemical composition of the wood framing the chimney chase, thereby reducing the temperature at which it would ignite, until eventually, on November 11, 2011, the wood framing the chimney chase did ignite, which in turn resulted in the fire that damaged [the] house, for which [the homeowner’s insurer] was obligated to indemnify [the homeowner] as [the homeowner’s] insurer.23

The court of appeal stated such allegations and facts triggered the insurer’s potential liability because “the repeated exposure of the wood framing the chimney chase to the excessive heat in the chimney, for which Tidwell was responsible, may have caused physical injury to the wood (by altering its chemical composition and reducing its ignition point) during one or more policy periods” and “that physical injury would have caused Tidwell’s legal obligation to pay damages for the fire that resulted (at least in part) from the damaged wood.”24

That the damage alleged in the underlying complaint was for a fire that occurred after the policies expired, the court explained, “does not preclude the possibility of coverage because of the causal role that the degradation of the wood during one or more policy periods may have played in causing the fire for which [the homeowner’s carrier] sought to recover damages.”25 Specifically, “an initial causative event constituting an ‘occurrence’—namely, the repeated exposure of the wood framing the chimney chase to excessive heat in the chimney—may have resulted in property damage over a period of years—namely, the physical degradation of that wood—which in turn may have led ultimately to the fire in November 2011.”26 The injury to the wood resulting from the initial causal event, the court determined, may have constituted a further causal event in the chain between Tidwell’s negligent installation and the fire.

Modification of the Trigger

In response to evolving case law, insurers have drafted endorsements and nonstandard language modifying the trigger for occurrence-based CGL policies. Practitioners and corporate counsel need to be on the lookout for policy provisions requiring that the occurrence happen within the policy period, or mandating application of the so-called “manifestation” trigger.

One of these policy provisions was recently enforced in Bankers Insurance Com-

pany v. A-1 Air Conditioning & Heating, et al.27 There, the CGL policies contained an endorsement requiring the occurrence to take place during the policy periods. The endorsement modified the definition of occurrence, in relevant part, as follows: “‘Occurrence’ means an accident which results in ‘bodily injury’ or ‘property damage’ that first occurs during the policy period and is neither expected nor intended by an insured. ‘Bodily injury’ or ‘property damage’ first occurs during the
a condition where it reasonably should have been known, by [the insured].”32

The court granted St. Paul’s motion, concluding there was no evidence that the damage “first manifested” during the St. Paul policy period. While there was expert testimony showing damage had started occurring during the St. Paul policy period, nothing proved the insured knew or had reason to know the damage was occurring at that time, as required by the policy endorsement.

Policyholder and corporate counsel should be aware of these nonstandard endorsements and provisions, as well as their potential implications, since they may significantly impact coverage available for latent construction defect damages. Counsel should consider advising clients to discuss these endorsements/provisions with their brokers and, if possible, remove the limiting language.

**Business Risk Exclusions**

To deny coverage for construction defect claims, insurance carriers also frequently cite Exclusions j(5) and j(6), known as “business risk” or “ongoing operations” work exclusions. Exclusion j(5) in the 1986 and later ISO CGL policies reads in relevant part as follows: “This insurance does not apply to: ‘Property damage’ to… That particular part of real property on which you or any contractor or subcontractor working directly or indirectly on your behalf are performing operations, if the ‘property damage’ arises out of these operations….”33

Exclusion j(6) in the 1986 and later ISO CGL policies provides in pertinent part: “This insurance does not apply to… ‘Property damage’ to… (6) That particular part of any property that must be restored, repaired or replaced because your work was incorrectly performed on it….”34 An exception to the exclusion states: “Paragraph (6) of this exclusion does not apply to ‘property damage’ included in the ‘products-completed operations hazard.'”35

The term “your work” is defined as “(a) Work or operations performed by you or on your behalf; and (b) Materials, parts or equipment furnished in connection with such work or operations. ‘Your work’ includes warranties or representations made at any time with respect to fitness, quality, durability or performance of any of the items included in a. or b. above.”36

These “business risk” exclusions apply to property damage arising while the insured is still performing operations. When damage arises after the insured has concluded its operations, exclusions j(5) and j(6) will not preclude coverage.37 Disputes with respect to these exclusions generally involve fact-intensive inquiries: 1) the meaning of the phrase “that particular part” (i.e., the entire contractual undertaking versus the immediate area of the work where the property damage arose); and 2) when the work performed by the insured, or on the insured’s behalf, was complete.

A California federal court recently analyzed the applicability of these exclusions in the context of a carrier’s duty to defend in **Tokio Marine Specialty Insurance Co. v. Thompson Brooks, Inc.**38 The contractor, Thompson Brooks (TBI), had been engaged as a general contractor to demolish and rebuild a house. Tokio Marine issued consecutive CGL policies to TBI that contained the standard ISO j(5) and j(6) exclusions.39 With regard to the coverage dispute, the court denied the insurer’s motion for summary judgment, concluding Tokio Marine owed a defense because disputed issues of material fact remained, thus implicating potential coverage. These issues were “how ‘complete’ the Project was at the time of termination (or abandonment)” and “whose work caused the property damage and which parts of the Project were damaged….”40

As to Exclusion j(5), the court stated factual issues remained as to 1) whether the alleged damage arose out of TBI’s operations or third parties not under TBI’s control, 2) the time and location of damage, and 3) the scope of and likely cause of damage. As to Exclusion j(6), factual issues remained as to 1) whether the alleged damage arose out of TBI’s operations or third parties not under TBI’s control, 2) the time of damage, and 3) whether the work was abandoned or completed, which would trigger the exception to the exclusion. The court thus ruled neither exclusion precluded Tokio Marine’s duty to defend.

In another recent federal decision, **Archer Western Contractors, Ltd. v. National Union Fire Insurance Co. of Pittsburgh, Pennsylvania,**41 Exclusions j(5) and j(6) were found to preclude an insurer’s duty to indemnify for a defective work lawsuit settlement. A construction defect lawsuit had been filed against Archer Western with respect to its work on an emergency water storage project. National Union denied coverage, citing standard ISO j(5) and j(6) exclusions in its commercial umbrella liability policy.42

The district court granted National Union’s summary judgment motion, ruling the exclusions precluded the insurer’s duty to indemnify. With respect to exclusion j(5) (labeled “e(5)” in National Union’s policy), the court stated “[i]n the case of a general contractor…the ‘particular part of the property’ is the entire project.”43 Archer Western was the general contractor responsible for construction of the pump house and installation of the turbine generators, and all the alleged property damage was to those components. The court thus determined the “particular part of the property” on which the general contractor was working encompassed both the pump house and the turbine/generators. The court also determined, construing the term “arising out of” broadly, the alleged property damage arose out of Archer Western’s work. The trial court reasoned that Exclusion j(6) (“e(6)” in National Union’s policy) precluded coverage because the damages arose solely from the contractor’s defective work during the course of construction, including construction of the pump house and installation of the turbine/generators.

Archer Western appealed. The Ninth Circuit affirmed, explaining that “California courts and federal courts interpreting California law have construed ‘that particular part’ to encompass the entire project on which a general contractor is performing operations.”44 The court noted that California courts and federal courts interpreting California law “have construed ’that particular part’ to encompass the entire project on which [Archer Western] was partially if not fully responsible, and the damage flowed from its allegedly defective work on the property.”45 The court also rejected the insured’s argument that the exclusions were ambiguous.

**Defenses to Exclusions**

As has been seen, exclusions j(5) and j(6) sometimes provide carriers with powerful defenses to coverage. Although an insured’s best response to these exclusions is not to have them in the policy in the first place, policyholders still have a number of generally applicable defenses at their disposal. The extent to which these defenses apply will, naturally, depend on the precise policy language and facts presented.

First, it is a basic rule of California law that “exclusionary clauses are interpreted narrowly against the insurer.”46 Second, “[p]rovisions which purport to exclude coverage or substantially limit liability must be set forth in plain, clear and conspicuous language.”47 In addition, Exclusions j(5) and j(6) may not preclude a carrier’s defense obligation in many cases. An insurer’s duty to defend is greater than
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its duty to cover, and the duty to defend is interpreted broadly under California law. In most cases, the pleadings are unlikely to eliminate the potential that alleged property damage arose after the insured completed its work, or to resolve the questions of the scope and likely cause of the property damage.

An insurer must defend its insured against claims creating even a potential for indemnity. The duty to defend is excused only when “the third party complaint can by no conceivable theory raise a single issue which could bring it within the policy coverage.” Moreover, the entire action must be defended if there is any potentially covered claim. “The determination whether the insurer owes a duty to defend usually be defended if there is any potentially covered claim.51 “The determination whether the insurer owes a duty to defend usually be defended if there is any potentially covered claim.51 “The determination whether the insurer owes a duty to defend usually be defended if there is any potentially covered claim.51 “The determination whether the insurer owes a duty to defend usually be defended if there is any potentially covered claim.51 “The determination whether the insurer owes a duty to defend usually be defended if there is any potentially covered claim.51 “The determination whether the insurer owes a duty to defend usually be defended if there is any potentially covered claim.51 “The determination whether the insurer owes a duty to defend usually be defended if there is any potentially covered claim.51 “The determination whether the insurer owes a duty to defend usually be defended if there is any potentially covered claim.51 “The determination whether the insurer owes a duty to defend usually be defended if there is any potentially covered claim.51 “The determination whether the insurer owes a duty to defend usually be defended if there is any potentially covered claim.51 “The determination whether the insurer owes a duty to defend usually be defended if there is any potentially covered claim.51 “The determination whether the insurer owes a duty to defend usually be defended if there is any potentially covered claim.51 “The determination whether the insurer owes a duty to defend usually be defended if there is any potentially covered claim.51 “The determination whether the insurer owes a duty to defend usually be defended if there is any potentially covered claim.51 “The determination whether the insurer owes a duty to defend usually be defended if there is any potentially covered claim.51 “The determination whether the insurer owes a duty to defend usually be defended if there is any potentially covered claim.51 “The determination whether the insurer owes a duty to defend usually be defended if there is any potentially covered claim.51 “The determination whether the insurer owes a duty to defend usually be defended if there is any potentially covered claim.51 “The determination whether the insurer owes a duty to defend usually be defended if there is any potentially covered claim.51 “The determination whether the insurer owes a duty to defend usually be defended if there is any potentially covered claim.

53 See id. at 1264-65.
54 See id. at 1275 (citations omitted).
55 See id. (citations omitted). The court also noted the trial court could have disbelieved them or discounted their testimony. See id. at 1278 (citations omitted).


See id. at §6:44.


See id. at 1277 (citation omitted). The court also noted the trial court could have disbelieved them or discounted their testimony. See id. at 1278 (citation omitted).


See supra note 1, at §6:44.

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and prior use of commercial and industrial properties in Southern California, including the region’s numerous and vast oil fields (and related operations like refineries, tank farms, and gas stations), the aerospace industry, metal plating operations, circuit board manufacturing, and defense-related operations and manufacturing, means that contaminated sites are often the rule here, not the exception. Few commercial or industrial properties—including manufacturers, dry cleaners, hospitals, gas stations, office buildings, and even undeveloped properties—are immune from being impacted by contamination whether from an on-site or off-site source. At the same time, federal and state environmental statutes have broad reach, covering past and present owners of contaminated real property, as well as lessors, lessees, and operators.

The potential, and often actual, liabilities involving contaminated properties, while sometimes not obvious, can result in tremendous cleanup costs, long delays in the property’s reuse or development, decreased value or use of the property, and claims from employees, lessees, and adjacent property owners. A prime example of such damages and liabilities can and often have resulted from a dry cleaner shop that is part of a strip mall. Long-term operational spills or leaks of the chemicals often used in the dry cleaning process can migrate into the soil and groundwater, spreading throughout the property and onto adjacent properties. This can result in expensive site assessment and remedia-tion costs as well as expose the operator of the business and the property owner to toxic tort claims from individuals—including employees—who allege adverse impacts from the chemical vapors. Such contamination can also adversely impact the value and marketability of the parcel on which the dry cleaner store is located. Thus, it is incumbent to recognize the environmental liabilities that may arise in purchasing, selling, developing, and leasing real property, and to develop a strategy to avoid, or at least minimize, these liabilities.

Thorough due diligence is essential in any real estate transaction. Many sources exist to obtain information and documentation on the environmental condition and history of a given property. These include Internet-accessible databases like the State Regional Water Resources Control Board’s GeoTracker database that tracks and archives compliance data on waste discharges to land and groundwater and releases of hazardous substances from underground storage tanks. EnviroStor, the California Department of Toxic Substances Control’s (DTSC) data management system, tracks DTSC cleanup, permitting, enforcement, and investigative actions into hazardous waste facilities and sites with known contamination. Aerial photographs may also help reveal evidence of past operations or spills. Phase I environmental reports that the current or prior owner, operator, or lessee may have prepared are another source. A Phase I Environmental Site Assessment is designed to identify recognized environmental conditions based upon a review of available public records, interviews and visual inspections but

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Because contamination does not respect property boundaries, it is also prudent to obtain information about the environmental condition of adjacent properties through GeoTracker, EnviroStor, or other sources. For example, if a neighboring site has a soil or groundwater problem, it is valuable to know if this contamination may have migrated onto or under the subject site. This contamination may have numerous impacts on a client’s property, including groundwater contamination flowing toward the property or soil vapor contamination arising from the subsurface into buildings, thus posing a potential health threat.

### Site Testing

A prospective buyer, lessee, or developer should consider conducting tests on the property. The nature and scope of environmental testing will depend on many variables, including the buyer’s willingness to incur this expense, an owner’s cooperation in allowing the testing, and the parties’ negotiation on the time granted for this investigation. Generally, conducting and completing environmental due diligence testing exceeds initial estimates. Accordingly, parties are advised to allow a sufficient due diligence period and provide options to extend the closing date so the buyer may thoroughly evaluate the test data and conduct further testing as needed. Assuming the owner permits a buyer, lessee, or developer to proceed with an environmental investigation, several important factors must be determined and evaluated.

First, what are the types and characteristics of contaminants impacting the property? Are these impacts limited to the soil or do they extend to indoor air or groundwater or both? A buyer may encounter a vast range of contamination conditions from those that are manageable as to time and money to those that are long-term, high risk, and expensive to remediate. For example, environmental agencies often consider soil contaminated by low levels of total petroleum hydrocarbons (i.e., gasoline-related contamination) as posing a “low threat” to human health and the environment; therefore, these agencies are usually amenable to relatively inexpensive remedial options such as natural attenuation, excavation, and soil vapor extraction. By contrast, chlorinated solvents such as tetrachloroethylene (PCE) or trichloroethylene (TCE)—chemicals commonly associated with dry cleaners, circuit board production, and metal plating operations—often result in contamination to soil, soil vapor, and groundwater. Remediation of solvent contamination often takes several years, is very expensive, and may pose health risks to on-site employees due to soil vapors migrating onto the property or the indoor air of on-site buildings or both. Accordingly, a determination that property is “contaminated” is a wholly insufficient evaluation of its environmental condition. Knowledge and understanding of the chemicals impacting the property, the media (i.e., soil, soil vapor, air, or groundwater) which may be or is affected, the cost and time of remediation options, and the health risk factors to on-site employees or off-site neighbors are important factors to be considered.

Second, integral to determining what chemicals may be present on the property is learning the nature and extent of both past and current operations conducted on it. “Out of sight, out of mind” is not a good strategy. This investigation should include evaluating if there were or still are any subsurface “buried treasures” at the property. Underground structures such as tanks, sumps, clarifiers, and their attendant piping that were or are on-site must be identified. Were any underground structures abandoned in place or were they removed? What chemicals—gasoline products or potentially more problematic solvents—were stored or used in these tanks? Does documentation exist, e.g., disposal records or removal permits? An investigation of environmental operations, both those conducted below and above ground, must be made. Did the facility have storage areas, whether inside the building or out in the “back forty” near a fence line, where drums or other waste products may have been stored? Are there indicia of past spillage from drums or leaks from vehicles such as forklifts that may have been operated on-site? Is there evidence of chemical releases from or near the site’s manufacturing areas or equipment? Is there any evidence of past fires or flooding that may have caused or exacerbated an environmental condition?

Examining the building itself is sometimes overlooked in investigations. When dealing with older, pre-1980 buildings, testing for asbestos-containing building materials (ACMs) should be done in the roof, ceiling, flooring, dry wall, or insulation areas. Any ACMs in good condition should not pose a problem but those in poor condition can cause exposure to friable asbestos, especially during remodeling, building construction, or demolition. All ACMs require special handling when being removed from the property. Older buildings may also contain other potentially hazardous materials or chemicals like lead or polychlorinated biphenyls (PCBs) that will require similar treatment.

Third, agency actions relating to the property must be researched. Has the local regional water quality control board, the DTSC, the South Coast Air Quality Management District, a local hazardous material agency, a certified unified program agency, or the U.S. Environmental Protection Agency (EPA) been involved with the site by issuing a permit, a cleanup and abatement or compliance order, or notice of violation? Has a closure or no further action letter been issued regarding the property? The issuance of either letter is beneficial but the scope and protection offered by it must also be evaluated and completely understood. Some prospective buyers may incorrectly assume that a closure letter necessarily covers the entire site and, thus, no further environmental due diligence is required. This assumption can be a big mistake because a closure letter may only apply to one aspect of a past operation like underground tanks but may not cover others with different environmental implications at other locations on the property. Alternatively, a closure letter may only apply to soil contamination and not groundwater contamination. Further, a letter issued by a local agency may not be recognized by a state agency that has taken over as the site’s lead agency. Also, most closure letters contain “re-opener” language allowing an agency to seek more testing or additional remediation if new information becomes available or if cleanup standards applicable to the relevant contaminants change. For example, because of the recent focus by many agencies on vapor intrusion inside buildings, which results from volatile chemicals emitting gases upward from below surface soil or groundwater, it is now not uncommon for a closure letter to be reopened by an agency to require testing for indoor vapor intrusion.

A thorough environmental assessment should include establishing a baseline of a property’s contamination levels before a transaction closes. Important risk and liability allocations can often depend on this environmental baseline. For example, if a lessee demonstrates through a baseline report that it never used a certain chemical or product in its operations that has now become the focus of an environmental investigation or cleanup order, the lessee may avoid liability to the government or a third party seeking redress due to a chemical used by the lessee’s predecessor. Similarly, a former owner may be able to rely on an environmental baseline report as evidence that that owner never handled a chemical that is now the subject of a cleanup order or lawsuit by an adjacent
1. Contaminated sites throughout Southern California are primarily a result of the pervasiveness of gas stations in the region.
   True.
   False.

2. Federal and state environmental statutes can hold responsible current owners, past owners, lessees, and operators.
   True.
   False.

3. Environmental agencies such as the California State Regional Water Quality Control Board do not make accessible online database information about contaminated sites they regulate.
   True.
   False.

4. A Phase I report identifies environmental conditions and also includes site sampling for contaminants.
   True.
   False.

5. A seller of property is obligated to allow a prospective buyer to conduct site testing for contamination.
   True.
   False.

6. It is more likely for petroleum-related contamination to be determined to pose a low threat to human health than contamination from chlorinated solvents.
   True.
   False.

7. Operations that use PCE or TCE, e.g., dry cleaners, can often result in contamination to soil, soil vapor, and groundwater.
   True.
   False.

8. When considering the purchase of a commercial or industrial building, it is not necessary to inspect any of the building materials themselves for potentially hazardous materials.
   True.
   False.

9. A closure or no further action letter may be “reopened” by an agency.
   True.
   False.

10. The recent focus of environmental agencies on the issue of indoor vapor intrusion has led to closed sites being reopened for further testing.
    True.
    False.

11. Allowing for preclose environmental testing by the prospective buyer is always a good idea for the seller because it will help to close the transaction.
    True.
    False.

12. It is prudent for a seller and buyer to enter into a site access agreement before a buyer conducts testing on the seller’s property.
    True.
    False.

13. Environmental indemnifications between a buyer and seller can be tailored as to scope of time and specific contaminants and chemicals that are included or excluded within the indemnification.
    True.
    False.

14. Insurance policies from the early 1980s are no more valuable than recent policies with regard to providing protection from environmental claims.
    True.
    False.

15. It is a good idea for an owner to conduct an environmental prescreen of a prospective tenant’s operation and chemical usage because an owner may be held liable for its tenant’s contamination.
    True.
    False.

16. It is prudent for a lessor to establish an environmental baseline of the condition of its property and past chemical usage before the commencement of a lease.
    True.
    False.

17. Certain environmental agencies offer a cost oversite agreement whereby an owner can have the agency review and approve its remediation plans for a cost.
    True.
    False.

18. Cleanup standards do not vary between commercial uses and residential or school uses.
    True.
    False.

19. If a seller is aware of its property’s contamination, it need not disclose it to the buyer if the deal is an “as-is” transaction.
    True.
    False.

20. The California Land Reuse and Revitalization Act provides bona fide purchasers and innocent landowners a process to conduct site assessment and implement a cleanup action in exchange for being provided with governmental immunity against agency action.
    True.
    False.
landowner. Thus, in litigation among various parties (i.e., between and among past and current owners and operators) involving the allocation of responsibility for cleanup costs, a strong defense can often turn on a party’s ability to produce evidence that during its ownership or operation it did not use those chemicals that caused the contamination. Detailed record-keeping and past environmental reports can be an important part of such an evidentiary showing.

**Owner/Seller Perspective**

An owner of contaminated property has certain options to limit its liability when selling or leasing the property. A buyer will likely want to do a thorough environmental investigation, including conducting on-site testing of the soils or groundwater or both. The owner has the right and discretion to allow or disallow this request. If prior testing has already been conducted, the owner may ask the buyer to rely on that test data by providing a copy of the existing environmental report or other documentation in the owner’s possession. Indeed, even in an “as is” transaction, an owner who knows or has reasonable cause to believe hazardous substances have been released on its property may be obligated statutorily to disclose this condition to the buyer.

Allowing the prospective buyer to conduct testing has both rewards and risks. The former is new test data that may be obtained showing no new or unforeseen contamination. In turn, this new data becomes an important part of the property’s environmental baseline. In addition, the baseline may enable the seller to refute future claims that erroneously allege certain contamination existed when the transaction occurred. Perhaps most beneficial of all, allowing the buyer to conduct preclosing testing provides an incentive to move forward with the transaction. In contrast, a risk of permitting preclosing testing is that additional contamination will be discovered, resulting in the buyer’s seeking to reduce the purchase price or terminating the deal altogether. Also, the owner may then face the prospect of incurring unanticipated cleanup costs for a property that has now become less valuable or even unmarketable. Finally, the owner will have to disclose this new contamination information to the next buyer.

If an owner permits preclosing testing, a well-drafted access agreement is beneficial. An access agreement can allocate liability to the buyer for damage caused by its testing, including exacerbating any existing environmental conditions. Second, the buyer must return the property to its pre-testing condition. Third, the buyer must engage an environmental consultant who is experienced in these investigations and holds any required licenses while maintaining certain mutually agreed upon insurance coverage. The owner should request to be named as an additional insured and that the consultant’s insurance coverage not be limited to the cost of the subject testing. Fourth, the owner may want to request splits of the testing samples to decide whether to retain its own environmental consultant to check the test data for any discrepancies or false positives. Alternatively, the owner may request that the buyer conduct the testing and ask the buyer not to share the test results with the owner so the latter remains unaware of facts that it would have to later disclose to other prospective buyers if the transaction does not close. Further, the owner should also carefully review and approve the scope of testing being requested by the buyer. Subsurface testing may be viewed as overly intrusive (i.e., inside the building or underneath the building’s foundation or surrounding property). Also, a reasonable deadline by when the buyer must complete testing needs to be set. Test results can be inconclusive thus leading to requests for more testing. One consideration to mitigate time delays and test result uncertainty is to ask the buyer to make agreed upon nonrefundable payments for due diligence time extensions or for other inconveniences or delays due to preclosing testing.

**Mitigation Strategies**

An owner also has other risk mitigation strategies that can be followed. On one end of the spectrum, the seller can market the transaction as is and request the buyer indemnify the owner for any new contamination caused by the buyer or its successors after they take possession of the property. An as-is transaction, however, will likely result in the buyer’s getting a less-than-market-value purchase price offer because the buyer is assuming the risk if the property is contaminated. Although an as-is transaction for contaminated properties is the exception, it should not be summarily ruled out under the right circumstances. For example, a sophisticated buyer may want a contaminated site due to its location, size, infrastructure, or other factors and will have the resources to make a reasonably accurate evaluation of the property’s environmental condition and, thus, may be willing to assume certain risks in obtaining that site.

In lieu of an as-is deal, the owner may seek to minimize future liability by negotiating that the indemnification provided to the buyer be restricted in scope or by time or restricted to a certain dollar amount. Indemnification can be tailored so if an environmental claim arises within five years of the closing date, the owner would bear the entire responsibility for any claims or losses. However, the owner’s liability could be reduced, for example, to 75 percent at seven years and then to 50 percent at 10 years, and so on. If—based on the property’s environmental baseline report prepared during the transaction—it is determined the owner’s operations only included contaminants referred to as “heavy metals” such as lead, nickel, copper, or cadmium, indemnification may be limited only to cover future claims related to those contaminants. In lieu of a complete indemnity, an owner can offer to assign its rights under any comprehensive general liability insurance policies that the owner held during its ownership if a third party claim later materialized. This could be especially favorable to a buyer for policies from 1986 or before since these policies did not contain the absolute pollution exclusion language that is included in more recent policies. An insurance assignment can be offered as an alternative to other monetary concessions that the seller may otherwise need to provide to the buyer. Similarly, an owner may offer to assign its rights to claims it may have against prior property owners or operators in the chain of title. This assignment of an owner’s insurance rights or its claims against its predecessors can replace offering more stringent indemnification language to the buyer.

If the buyer’s plan to redevelop the property includes excavating for subterranean parking in areas in which there is known contamination, the owner may consider an agreement whereby its responsibility is limited to the incremental costs the buyer incurs in treating, remediating, handling, transporting, and disposing of the contaminated soil or groundwater. This limits seller’s future costs to the differential between the cost of excavating and handling, including treating, remediating, transporting, and disposing of the contaminated soil or groundwater. This limits seller’s future costs to the differential between the cost of excavating and handling, including treating, remediating, transporting, and disposing of, contaminated materials and the cost that the buyer would otherwise incur for excavating and handling the same materials if not contaminated. This is an equitable allocation formula for both buyer and seller.

**Lessor's Minimization Strategies**

A lessor of commercial or industrial property must become fully aware of the business operations that a prospective tenant or its subtenants intend to conduct, espe-
cially their potential environmental impacts. The tenant should be asked if its business uses or generates hazardous waste as a by-product of its operations. Will the tenant use or install underground storage tanks on the property or emit air pollutants? Will chemicals be used, stored, treated, or otherwise handled as a part of the tenant’s business? An affirmative answer to any of these questions raises a distinct possibility of significant risk or exposure. A good tenant prescreening device is to require all tenants to complete a prelease comprehensive environmental checklist that requires them to disclose detailed information on the materials that they plan to use in waste management practices, a past environmental compliance history, and insurance information and claims history. In addition, tenants need to provide copies of any environmental permits they have or applications for permits needed to operate on the property. Too many red flags or uncertainties revealed in this prelease checklist may provide a valid reason to pass on certain prospective tenants. Obtaining this type of information is good protocol for large and small tenants alike. Indeed, “mom and pop” operations such as dry cleaners or small tooling shops can create large environmental problems because of the chemicals used, and these tenants usually do not have the assets necessary to remediate the environmental problems their operations may cause.

Lease provisions related to environmental issues also must be reviewed carefully. What may seem like an otherwise favorable, lessor-oriented lease may leave a lessor wide open to environmental liabilities for the tenant’s activities. Some standard commercial and industrial leases still do not include language specifically referring to issues and liabilities related to hazardous waste and hazardous materials. Accordingly, it is important to include specific language in the lease that addresses these issues. However, even if the tenant is considered responsible for environmental liabilities under the lease, these assurances may be of little moment if the tenant is financially incapable of assuming the liabilities. An extra month’s rental deposit will not begin to cover the expense of a cleanup. Thus, a landlord should consider requiring the tenant provide some alternative form of financial assurance demonstrating it will have the resources to actually indemnify the lessor if an environmental problem arises. This is especially important since a lessor/owner can be held liable for the tenant’s contamination just based on ownership status.15

Just as in the purchase and sale context, a lessor should establish an environmental baseline detailing the condition of the property and past chemicals at the lease’s inception. Contested proceedings involving which party is responsible for any contamination are often ultimately determined by evidence of what party used what chemicals and when.

**Buyer’s Perspective**

A first and fundamental step in managing and limiting liability is to undertake a thorough environmental due diligence of the property and its environs. Information and documentation can and should be obtained from a number of sources, including the agency websites GeoTracker and EnviroStor, aerial photographs, and a review of prior environmental reports regarding the property and of neighboring properties. In addition, testing the soil and groundwater to determine the current status of the property is advisable. Based on this collection of information, which should be carefully reviewed by an experienced environmental consultant and environmental attorney, a prospective buyer will be in a better position to determine the risk and rewards of moving forward with the purchase of a contaminated property.

Among the factors to determine is the nature of the existing contamination. The buyer should evaluate the time and expense likely needed to remediate the problem. What are the remediation options—excavation, soil vapor extraction, chemical injection to neutralize the contamination, natural attention—or a combination of these options? A determination should also be made as to whether use of the property or its redevelopment can proceed while remediation is ongoing, or whether the buyer’s plans will have to be put on hold or scaled back during remediation.

Another important factor to consider is whether existing contamination poses an actual or potential health risk to employees or tenants at the site. Specifically, a determination should be made as to

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**Summary of the Prospective Purchaser Agreement Fact Sheet**

1. The site falls under jurisdiction of the California Department of Toxic Substances Control (DTSC) because an actual hazardous substance release exists.
2. The prospective purchaser offers to enter into an agreement with the DTSC whereby that purchaser will pay the DTSC for oversight costs and commits to ensure the response action will completely remediate the site or will make significant progress toward complete remediation.
3. Unauthorized disposal of hazardous waste is not currently occurring at the site.
4. The prospective purchaser is not a responsible party or affiliate of a responsible party with respect to the hazardous substance release(s) when the time the agreement is executed.
5. A Preliminary Endangerment Assessment (PEA)2 or equivalent has been performed and provided to the DTSC identifying the hazardous substance releases at the site.
6. The hazardous substance release site is not the subject of an active enforcement action or agreement with another agency with jurisdiction over the remediation unless that agency transfers oversight to the DTSC.
7. The public will receive a substantial benefit from the PPA that would not otherwise be available (e.g., potential environmental benefits, significant progress towards site remediation, value to the community in terms of additional jobs, an increased tax base, or opportunities for disadvantaged groups).
8. The continued operation at the site or new site development, with the exercise of due care, will not exacerbate or contribute to the existing contamination or interfere with the investigation of the extent, source, and nature of the hazardous substance releases(s) or the implementation of remedial or removal actions.
9. The effect of continued operation or new development on the site will not result in health risks to those persons likely to be present at the site.
10. The prospective purchaser is financially viable and willing to provide financial assurances and has sufficient funds to complete the investigation and remedial action.
11. The prospective purchaser is a “bona fide prospective purchaser” (i.e., a person or entity purchasing all or part interest in real property, but is not affiliated with any person potentially liable for response actions at a site). The bona fide prospective purchaser must provide evidence of these conditions to the DTSC.

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2 The PEA is an initial step into the investigation of a site and provides basic information to help determine if there has been a release of a hazardous substance that presents a risk to human health or the environment. See Preliminary Endangerment Assessment Guidance Manual, Cal. Dept. Toxic Substances Control, (Jan. 1994, revised Oct. 2015) available at http://www.dtsc.ca.gov.
whether vapor intrusion exists at the site or in any construction at the site. A related determination is whether the risk of subsurface vapors can be managed by installing vapor barriers or other on-site engineering mechanisms. The cost of doing this can then be factored into the purchase price. If the buyer recognizes that some post-purchase remediation will likely need to occur, consideration should be given to what the cleanup levels will need to be based on the property’s intended use. If the property is intended for a mixed residential-commercial use, cleanup levels will likely need to conform to more stringent residential remediation standards.16

The buyer should also determine if a particular environmental agency has previously been involved with the property based on prior events at the site. If so, the buyer should conduct due diligence on that agency’s remediation requirements, its general time frames for reviewing remediation plans, and the agency’s protocols for its issuance of closure letters. Some agencies offer a cost oversite option whereby a property owner or operator can enter into an agreement for the agency to review remediation plans and closure letter requests, for a cost.17

A buyer needs to be mindful of whether and to what extent adjacent properties may have been impacted by the subject site or may be impacting the subject site. For example, if the subject property has groundwater contamination that is migrating off-site, it is important to determine not just that fact but whether any off-site properties impacted include areas zoned residential, for school use, or for recreational/open space. Agencies consider these types of properties to be “sensitive receptors” so if remediation of these sites is required, the cleanup standards may be more stringent than for the subject property. Similarly, it is advisable to know if an off-site property has contamination that is migrating onto the subject site and, if so, if an agency has already ordered the off-site owner or operator to engage in remediation. This fact could make less likely the subject property owner’s being named a responsible party. Moreover, it is important to learn if the migrating contamination may lead to the placement of monitoring wells or other remediation equipment on the subject site. In addition, the prospective buyer should try to determine if the off-site contamination does or may pose an actual or potential risk to the subject property.

The purchase and sales agreement for a contaminated site should contain detailed provisions directed to the property’s environmental condition. For the buyer’s protection, the seller should provide environmental representations and warranties related to the site’s contamination; current and past operator’s use of and identity of chemicals; the status of activities undertaken by the seller or past operators or both to comply with all applicable federal, state, and local environmental statutory and regulatory requirements; whether there are pending environmental investigations, notice of violations, cleanup, and abatement orders or other environmental civil, criminal, or administrative proceedings related to the property; the identity and status of any and all environmental permits; and the seller’s compliance status regarding these permits. If the buyer intends to continue with the same business or operations conducted by the seller, determination should be made if the seller’s environmental permits are transferable, and, if so, the buyer should become familiar with the time frame required for such transfers to become operative.

In addition to the parties’ representations and warranties, the scope of indemnification being provided is perhaps the most actively negotiated and important provision in a purchase and sales agreement. The indemnification that a buyer can or should obtain will depend on the details of each transaction and the parties’ respective bargaining power as well as risk tolerance levels. Sales of contaminated properties can run the gamut from as-is transactions to a full and complete indemnification whereby the seller agrees to defend, save, indemnify, and hold harmless the buyer from and against any and all losses, claims, and lawsuits resulting from or arising out of the environmental condition of the property. Indemnification may be limited by time, dollar amounts, the types of contamination included, and whether, for example, the indemnity includes soil only, groundwater only, only on-site contamination, all contamination on, to, or from the property.

If a known environmental condition exists at the property that requires remediation, but the parties do not want to delay closing until remediation has been completed, one option is for the seller to commit to completing the remediation through its receipt of a no-further-action letter and holding back a portion of the purchase price until this letter is received from the lead agency.

A buyer may also seek protection under various government programs related to purchase of contaminated sites. For example, the California Land Reuse and Revitalization Act (CLRRA) of 2004 promotes the cleanup and redevelopment of blighted contaminated properties by providing liability protection to bona fide purchasers, innocent landowners, and contiguous property.18 It establishes a process for eligible property owners to conduct a site assessment and implement a response action, if necessary, to ensure the property is ready for reuse. In return, property owners will receive governmental immunity against action agency actions. This act has been extended to include prospective purchasers and bona fide ground tenants with a lease term of at least 25 years.19

Similar to CLRRA, DTSC makes available a prospective purchaser agreement (PPA) to certain qualifying buyers of contaminated properties, including a covenant not to sue from the DTSC. A PPA is limited to certain circumstances and requirements, which have been delineated in a fact sheet on the PPA compiled by the DTSC. (See Summary of the Prospective Purchaser Agreement Fact Sheet on page 31.)

The EPA offers programs for qualified purchasers of contaminated sites, including its Brownfields and Land Revitalization Programs, which are designed to empower states, communities, and other stakeholders in economic redevelopment to collaborate to prevent, assess, safely clean up, and sustainably reuse brownfields.20 Under these programs, the EPA offers funding and grants to local governmental entities and private parties for site assessments and cleanup activities. These programs seek to encourage private redevelopment, public-private redevelopment and public-led redevelopment.

All parties involved in real estate transactions related to commercial and industrial properties must be conscious of contamination issues. Obtaining information regarding the property’s environmental condition and understanding the nature and extent of the contamination that is or may be impacting the site is an important step in developing a strategy to best protect a party’s interests. Also, establishing an environmental baseline of the property’s environmental condition before a transaction is completed is important so it is clear what the nature of the contamination is before a deal closes.

Inclusion of indemnification and representation and warranties language in a transaction document, determining the existence and/or applicability of environmental insurance, and the pursuit of immunity protections offered under statutory provisions such as CLRRA are among the other devices a party can use to minimize its liabilities.

1 The State Water Resources Control Board’s GeoTracker database includes records relating to over
15,000 cleanup sites in the County of Los Angeles alone.


4 See e.g., 42 U.S.C. §9607[a]; HEALTH & SAFETY Code §25323.5(a).


8 Fact sheets relating to many toxic chemicals, including PCE and TCE, can be found at ATSDR Toxic Substances Portal, Agency for Toxic Substances and Disease Registry, available at https://www.atsdr.cdc.gov/substances/index.asp.

9 For more information on PCBs, which have been used as coolants and lubricants in transformers, capacitors, and other electrical equipment, see Polychlorinated Biphenyls - ToxFAQs™, Agency for Toxic Substances and Disease Registry, available at https://www.atsdr.cdc.gov/toxfaqs/facts17.pdf (last viewed Nov. 16, 2017).

10 Certified unified program agencies are local agencies certified by the DTSC to enforce state regulations. See generally HEALTH & SAFETY CODE §§25404–25404.9.

11 Governmental oversight agencies often issue “no further action” or closure letter after the owner, operator, or other responsible party has met the agencies’ corrective action requirements. See, e.g., the discussion relating to case closure procedures as part of the Underground Storage Tank Cleanup (UST) Program at UST Program–Cleanup, State Water Resources Control Board, https://www.waterboards.ca.gov (last viewed Nov. 17, 2107).

12 H EALTH & S AFETY C ODE Ch. 6.82, 6.83.
While cases of actual fraud emphasize the transferor’s intent, claims of constructive fraudulent transfer focus on the good faith of the transferee.

As litigation becomes more costly, attorneys are increasingly faced with clients who find themselves short of cash to fund the litigation process. When this happens, attorneys are put in the position of either abandoning the client or, in the case of a client with assets but cash flow issues, to obtain security for the future payment of fees, such as a real property lien. But even when an attorney carefully documents the transaction and complies with the ethical rules involving lien transactions, the attorney may still end up out in the cold: what happens if the client files for bankruptcy? The answer depends on the laws of fraudulent transfer and preferences.

Once the client files for bankruptcy, the trustee in bankruptcy will have broad powers to grow the bankruptcy estate by, among other things, clawing back money previously paid by the debtor to a creditor. The trustee’s goal is to treat creditors fairly and to prevent the debtor from preferring a favored creditor over another creditor prior to bankruptcy. The trustee’s powers include the power to set aside and avoid liens securing payment of debt, including attorney fee liens or deeds of trust securing future payment for services previously performed or for services to be performed in the future. The two legal avenues available to the bankruptcy trustee are fraudulent transfer actions and preference actions under the Bankruptcy Code.

Fraudulent transfer actions—even if brought in the bankruptcy courts—require application of the California version of the Uniform Voidable Transactions Act (UVTA) formerly known as the Uniform Fraudulent Transfer Act. Under the UVTA, California Civil Code Section 3439.04 authorizes claims based on actual and constructive fraudulent transfer. Actual fraudulent transfer requires proof that the transfer was made “[w]ith actual intent to hinder, delay, or defraud any creditor of the debtor.” Constructive fraudulent transfer is a transfer “[w]ithout receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor either was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction,” and the debtor “[i]ntended to incur, or believed

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or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due.”

Section 3439.04 has been amended to add the burden of proof for the elements as follows: “A creditor making a claim for relief under subdivision (a) has the burden of proving the elements of the claim for relief by a preponderance of the evidence.”

“Under both the UVTA and 11 U.S.C. §548 of the Bankruptcy Code, the Trustee has the burden of proving the elements of a fraudulent transfer by a preponderance of the evidence.”

Constructive fraudulent transfer under the U.S. Bankruptcy Code requires proof that a debtor “received less than a reasonably equivalent value in exchange for such transfer or obligation; and... was insolvent on the date that such transfer was made or such obligation was incurred....” A Chapter 7 trustee’s power to avoid liens is provided in 11 USC Section 544. To avoid transfers pursuant to Section 544(b) of the Bankruptcy Code, the trustee steps into the shoes of an unsecured creditor who “had a viable claim against [the] debtor at the time the bankruptcy petition was filed.”

One creditor of any amount will suffice for the purposes of § 544(b). The trustee is subject to any defenses that can be asserted against the creditor. “If the creditor is estopped or barred from recovery for some...reason, so is the trustee.”

A trustee in bankruptcy steps into the shoes of the creditor as of the time of the challenged transfer. The idea is that the creditor has been harmed by the debtor because the debtor left the creditor unpaid while taking care of another creditor and then filing bankruptcy. Critical to the analysis is whether the creditor had the legal right to void the transfer when the transfer was made. Thus, when an attorney records a deed of trust to secure unpaid legal fees and the client files for bankruptcy, the question is whether, at the time of the transfer, the creditor into whose shoes the trustee steps could have avoided the lien as a fraudulent transfer.

**Wyzard v. Goller**

California case authority is scant on whether a lien obtained by an attorney to secure payment of attorneys’ fees is subject to a claim of fraudulent transfer. In **Wyzard v. Goller**, the California Court of Appeal held that a transfer by a debtor to his attorney in the form of a promissory note and deed of trust for payment of legal fees rendered in litigation was not a fraudulent transfer as a matter of law. In **Wyzard**, both the debtor and his counsel knew the litigation would result in a judgment against the debtor, and the preferential transfer of a deed of trust to the attorney for payment of legal fees would result in the debtor’s inability to pay the plaintiff-creditor. Nonetheless, the court of appeal held that the transfer to the attorney was not a fraudulent transfer because the preference of one creditor over another—something that may well be voidable by a bankruptcy trustee—is not a fraudulent conveyance under the California UVTA. It has also been held that the fact a preference hinders or delays other creditors in the collection of their claims does not automatically render it void, “nor does the fact that the preferred creditor had knowledge that such consequence would follow the preference.”

The **Wyzard** case, however, specifically dealt with legal services that had already been performed. The analysis becomes less clear when an attorney enters into a written agreement with a client for services to be provided in the future and obtains security for those services that is potentially detrimental to other creditors. What happens to a lien securing legal fees for services to be performed in the future when the lien is challenged by an unpaid creditor?

**Badges of Fraud**

The trustee bears the burden of proof to establish that a transfer was made with “actual intent to hinder, delay, or defraud any creditor of the debtor.” Because there is usually no direct evidence demonstrating actual intent, courts generally infer actual fraudulent intent from the circumstances surrounding the transaction—the so-called “badges of fraud.” In order to aid the fact finder in determining whether actual fraudulent intent exists, the California UVTA sets forth these “badges of fraud” in a nonexclusive, 11-factor test for determining whether a transfer was made with an actual intent to hinder, delay, or defraud a creditor.

Similarly, federal law has provided that proof of certain objective facts such as a “transfer to a close relative, a secret transfer, a transfer of title without transfer of possession, or grossly inadequate consideration would raise a rebuttable presumption of actual fraudulent intent.” The state of mind of the transferor is generally the focus of the analysis.

The **Wyzard** court found that “the presence of one or more [badges of fraud] does not create a presumption of fraud, but ‘is merely evidence from which an inference of fraudulent intent may be drawn.’” As a result, the court in **Wyzard** held that even though some of the 11 badges of fraud were present, they did not raise a triable issue of fact in that case because “[i]t was established and conceded that [the attorney] had rendered the services he claimed to have rendered, and thus, had earned the fee secured by the encumbrances.”

But when there is only a promise of future services given in consideration for the transfer, the more badges of fraud present, the more likely a fraudulent transfer will be found. If the trustee can present evidence that, for example, the lien was secretly entered into without notice to other creditors or that the consideration paid for the promised services was inadequate and the transferred interest was for substantially all of the debtor’s assets, the transfer could well be found to be fraudulent. On the other hand, when the lien is recorded, the attorney creditor has performed substantial services and continued to represent the debtor until the filing of bankruptcy, the badges-of-fraud analysis is less compelling.

Both federal and state authority appear to hold that even if an attorney is aware that the transfer will prevent other creditors from collecting on his or her debt, if the transfer is for payment of legitimate attorneys’ fees incurred by the debtor, there is no basis for a finding of actual fraudulent transfer. The **Wyzard** court expressly found that a transfer made in payment of legitimate legal services is not fraudulent, even if made in anticipation of possible liability and “with recognition that the transfer will effectively prevent another creditor from collecting on his debt.”

In the unreported Northern District Bankruptcy Court case **In re Guzman**, similar facts were considered, and the court concluded the evidence established no actual fraudulent transfer:

The evidence demonstrates that Pinch retained Duffy & Gunter to represent him in the damages phase of the Monterey County Superior Court action, and that the law firm, not surprisingly, required a substantial retainer. The evidence also established that Pinch did not believe that Plaintiffs were entitled to compensatory or punitive damages, and that he retained the law firm to vigorously defend himself in the damages phase of the litigation. If Pinch did not believe that the Plaintiffs were entitled to any damages, why would a payment to these attorneys indicate that he intended to hinder, delay or defraud their yet to be determined damages award?

While the focus for actual fraud is the intent of the transferor, in claims of con-
The more detailed the fee agreement is concerning how the attorney calculated the hourly rate and anticipated time estimated for the handling of the matter, the more likely the attorney will be able to show that fair value was exchanged for the transfer.

reasonably equivalent value. The focus is the good faith of the transferee and whether reasonably equivalent value for the lien was received by the debtor. Both state and federal law provide that a transferee is entitled to keep the transfer if the transferee can show that he or she “took in good faith and for a reasonably equivalent value.”

The Ninth Circuit has held that a promise of future performance may be considered value. In re Dixon, The Ninth Circuit found that the attorney’s “promise to represent [the client] was the consideration for the prepaid fee.” The decision held that in a classic legal fee retainer situation the consideration is the present promise of the attorney to represent the client on a given matter.

Relative Value
The courts have also looked at the relative value of the lien and the value of the security for the lien in determining whether reasonably equivalent value was given. In

Reasonably Equivalent
Under Section 548(a)(1)(A) and California Civil Code Section 3439.04, the trustee bears the burden of proving that the debtor failed to receive reasonably equivalent value in exchange for the lien. However, the phrase “reasonably equivalent value” is not defined in the California Civil Code or the Bankruptcy Code. As the court explained in In re Kemmer, defining reasonably equivalent value has been left to the courts: “There is no hard and fast rule in the Ninth Circuit as to what constitutes ‘reasonably equivalent value.’” The concept of ‘reasonable equivalence’ is not wholly synonymous with ‘market value’ even though market value is an extremely important factor to be used in the court’s analysis.” The test for determining whether reasonably equivalent value was given requires courts to “determine the value of what was transferred and to compare it to what was received.” The factors a court may consider include “the fair market value of what was transferred and received, whether the transaction took place at arm’s length, and the good faith of the transferee.”

The value of the transfer must be established as of the date of the transfer. In value.” But there are contrary cases and treatises that discuss in great detail whether under federal bankruptcy law an “executory promise” can serve as “reasonably equivalent value.” In re Treasure Valley Opportunities, Inc., the Idaho Bankruptcy Court pointed out a number of published opinions that held an executory promise could constitute value. The Bankruptcy Court in In re Treasure also pointed out that the cases that concluded a promise to provide future services could not constitut reasonably equivalent value relied on the bankruptcy treatise Collier on Bankruptcy; however, the Idaho court found that Collier had been misconstrued by those authorities and pointed out that even Collier acknowledged that an executory promise could constitute value “especially when the promise has been partially or totally fulfilled in good faith....”

The Ninth Circuit in In re Bigelow indirectly addressed whether a promise to perform future services is sufficient consideration to support a prepaid fee for future services. The bankruptcy appellate panel for the Ninth Circuit addressed whether a prepaid nonrefundable fee constituted a breach of the attorney’s fiduciary duty to his client within the meaning of the discharge exception under 11 USC Section 523(a)(4). In Bigelow, the Ninth Circuit was called on to interpret Washington state law that permitted a nonrefundable retainer for services not yet performed. The former client filed an adversary proceeding for return of the fee paid, alleging that it was a breach of fiduciary duty for the attorney not to refund the money. Relying on the Ohio Bankruptcy Court opinion In re National Magazine Publishing Company, The Ninth Circuit found that the attorney’s “promise to represent [the client] was the consideration for the prepaid fee.” The decision held that in a classic legal fee retainer situation the consideration is the present promise of the attorney to represent the client on a given matter.

actual knowledge of facts which would suggest to a reasonable person that the transfer was fraudulent.”

Therefore, it may be argued that when the lien was executed in order to provide a client with needed legitimate legal representation and the fee agreement and deed of trust were entered into in an arm’s-length transaction for which the debtor consulted independent counsel, the transaction should be viewed as one entered into in good faith and for fair value. The more detailed the fee agreement is concerning how the attorney calculated the hourly rate and anticipated time estimated for the handling of the matter, the more likely the attorney will be able to show that fair value was exchanged for the transfer. Naturally, evidence that fees were inflated, whether as a result of attorney-client collusion or otherwise, can be construed as evidence of lack of good faith and fair value.

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California, the Second District Court of Appeal in the recent unpublished decision Stoltenberg v. Sheppard, Mullin, Richter, & Hampton, LLP, approved a law firm’s filing of a lien on its client’s multimillion dollar art collection. The lien secured payment of accrued, but unpaid, legal fees incurred in litigation in an amount less than $1 million dollars—in other words, an amount much lower than the amount of the lien. Due in part to the existence of the lien, the plaintiffs in that litigation were unable to satisfy the judgment against the losing defendants, so they sued the law firm to set aside the lien, alleging actual and constructive fraud. In addressing the constructive fraud claim, the Second District noted that although the amount of the debt was substantially less than the value of the security, there was nonetheless proof of reasonably equivalent value. The court of appeal held that the Sheppard Mullin lien “was coextensive with the debt, not the security,” and that the premise of the [UVTA] is that the value of the interest transferred for security is measured by, and thus corresponds exactly to, the debt secured.”

It may very well be that a public policy argument wins the day. In the unreported case NAMA Holdings, LLC v. Dorsey & Whitney LLP, the Second District asserted public policy in connection with attorney liens for payment of fees even when other creditors might be prejudiced:

Attorneys must be free to put forth their best efforts in representing such a client and attempting to secure findings in the client’s favor. It would place an undue burden on attorneys and clients to require attorneys to evaluate the likelihood of potential clients prevailing in a case-in-chief and the contractual indemnity theories before ever agreeing to represent a client under threat of at some point being found to have engaged in a fraudulent transfer merely for accepting payment of their fees. That cannot be what the Legislature contemplated when it provided in Civil Code section 3439.08, subdivision (a), that a transfer that would otherwise be voidable (such as when the debtor made the transfer with actual intent to defraud another creditor) is not voidable against one who took in good faith for a reasonably equivalent value. The Second District in Stoltenberg also reasserted the “sound public policy” behind the holding in the Wyzard case: “Without the ‘Wyzard rule,’ attorneys will have less incentive to represent clients who cannot pay adverse judgments, particularly if entering into a security transaction like the one here exposes them to lawsuits seeking to void the preference.”

But what is even more compelling, the NAMA court stated plainly the definition for reasonably equivalent value in cases involving a lien securing payment of attorneys’ fees: “[T]he definition of ‘reasonably equivalent value’ is more straightforward: whether the value of the legal services… provided…was worth what [was] charged for those services.”

Based on the current state of the law, there is no definitive answer to the question whether a lien given in exchange for a promise of future legal representation will survive a fraudulent transfer attack. Nevertheless, based on the public policy recently reaffirmed by the California Court of Appeal, the case authority that an executoritory promise can serve as value, longstanding case authority that the value of the transfer must be evaluated at the time of the transfer when the promise is made and the rationale of Wyzard, it can be safely inferred that so long as the amount charged by the attorney for the services is reasonably equivalent to the services actually contemplated to be performed, and the promise to perform is genuine, such liens will be defensible in both state and bankruptcy forums. Notwithstanding the foregoing, a trustee could consider such a transfer as a voidable preference under the Bankruptcy Code—but that is a topic for another article.

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3 Civ. Code §3439.04(a)(1).
4 Civ. Code §3439.04(a)(2).
5 In re 3Dfx Interactive, Inc., 389 B.R. 842, 863 (Bankr. N.D. Cal. 2008), subsequently aff’d sub nom. In re 3DFX Interactive, Inc., 585 F. App’x 626 (9th Cir. 2014).
7 In re Acequia, 34 F. 3d 800, 807 (9th Cir.1994), quoting Karnes v. McDowell 87 B.R. 554, 558 (Bankr. S.D. Ill. 1988).
8 In re API Holding, Inc., 525 F. 3d 700, 703 (9th Cir. 2008).
9 In re Verico Indus., 704 F. 2d 1134, 1137-39 (9th Cir. 1983).
12 In re Acequia, 34 F. 3d 800, 807, 805-806 (9th Cir.1994).
13 Id.
14 The 11 factors are: 1) whether the transfer or obligation was to an insider; 2) whether the debtor retained possession or control of the property transferred after the transfer; 3) whether the transfer or obligation was disclosed or concealed; 4) whether before the transfer
was made or obligation was incurred, the debtor had
been sued or threatened with suit; 5) whether the
transfer was of substantially all of the debtor’s assets;
6) whether the debtor abstended; 7) whether the
debtor removed or conceded assets; 8) whether the
value of the consideration received by the debtor
was reasonably equivalent to the value of the asset
transferred or the amount of the obligation incurred; 9)
whether the debtor was insolvent or became insolvent
shortly after the transfer was made or the obligation
was incurred; 10) whether the transfer occurred shortly
before or after a substantial debt was incurred; and
11) whether the debtor transferred the essential assets
of the business to a lienholder who transferred the
assets to an insider of the debtor.
35 BFP v. Resolution Trust Corp., 511 U.S. 531, 541
(1994).
36 In re Cohen, 199 B.R.709, 716-17 (9th Cir. BAP
2001);
37 in re BIGelow, 271 B.R. 178, 189 (B.A.P. 9th Cir.
2001).
N.D. Ohio 1994).
39 Id.
40 Id.
41 NAMA Holdings, LLC v. Dorsey & Whitney LLP,
No. B238449, WL 4034358 at *8 (Cal. Ct. App.,
June 20, 2017), review denied (Sept. 27, 2017).
42 Id. at *6.
43 Stoltenberg v. Sheppard, Mullin, Richter, &
Hampton, LLP WL 2646646 at *1 (Cal. Ct. App.,
June 20, 2017), review denied (Sept. 27, 2017).
44 See also Garcia v. Garcia (In re Garcia), 494 B.R. 799,
815 (Bankr. E.D. N.Y. 2013) (“[As] a threshold matter,
the Complaint must be dismissed because it fails to
plead any facts concerning the value of…membership
interests as compared to the consideration received in
exchange for them.”).
45 Kalier v. Able Debt Settlement, Inc., 440 B.R. 526,
533 (8th Cir. BAP 2010); In re Calvillo, 263 B.R. 214
(W.D. Tex. 2000). See also BFP v. Resolution Trust
46 In re Calvillo, 263 B.R. 214 (W.D. Tex. 2000) (deter-
mination of reasonably equivalent value is inherently
fact-laden and turns on case specific circumstances).
47 In re First Commercial Mgmt Group, Inc., 279 B.R.
230 (Bankr. N.D. Ill. 2002).
49 In re Dixon, 143 B.R. 671, 681 (Bankr. N.D. Tex.
50 In re Treasure Valley Opportunities, Inc., 166 B.R.
The Strand of Atlantic City, 205 F. 2d 778, 784 (3d
Cir. 1953) (holding executory promise may be property
and “fair consideration” within the terms of the
Uniform Fraudulent Conveyance Act).
51 In re Treasure Valley Opportunities, Inc., 166 B.R.
at 705: “…the authorities noted by the trustee base
their conclusion that executory promises cannot be
fair value on statements to that effect in Collier on
Bankruptcy…. Even Collier qualifies this broad-sweep-
ing language:
When the thing promised cannot benefit the
creditors, an executory promise is certainly to be
condemned. When, however, the promisor is
solvent and the promise is enforceable, unless it is a mere promise of support, a transfer to
him in exchange for his promise should not
be held necessarily and automatically to have
no value, especially when the promise has been
partially or totally fulfilled in good faith and
the creditors have profited by a reduction of
their debtor’s obligations after the transfer
was made.”

When Governor Jerry Brown signed a record 15 affordable housing bills into law last September, renters, developers, public agencies, lenders, and tax credit investors had ample reason to celebrate. California now will have a dedicated source of funding that could raise $200 million to $300 million annually in multifamily housing developments for the homeless initially and, eventually, low-income families and seniors as well. In addition, voters will have the opportunity to approve a $4 billion housing bond measure in November, of which $3 billion is earmarked to subsidize affordable housing projects and support home ownership and $1 billion is allocated to the CalVet Home Loans Program.

The critical shortage of affordable rental housing throughout California, including Los Angeles County, was the catalyst for these legislative initiatives. According to a May 2017 study by the nonprofit California Housing Partnership Corporation (CHPC), Los Angeles County needs more than 551,807 rental units “to meet the needs of its lowest-income renters.” The CHPC also found the county’s “inflation-adjusted median rent increased 32 percent while median renter income decreased 3 percent from 2000 to 2015.” Finally, the study said “renters need to earn 4 times [the] local minimum wage to afford the median asking rent of $2,499” in the county.

As housing demand and rents skyrocketed, availability of federal and state funds to build or preserve units declined dramatically, especially after the governor and state legislature abolished community redevelopment agencies several years ago. Since 2008, the CHPC said, investment in affordable housing production in Los Angeles County has been reduced by nearly $457 million annually. In late 2016, an encouraging turnaround in funding began to occur. In November of that year, more than 77 percent of voters in the City of Los Angeles approved Measure HHH authorizing $1.2 billion in bonds over the next 10 years to develop approximately 10,000 homeless housing units. Last March, Los Angeles County voters approved a quarter-cent sales tax increase that could eventually generate $355 million annually to fund housing, rent subsidies, and services for the homeless.

Leveraging financing is key to developing affordable housing. In California, developers traditionally have relied on debt in the form of a private first mortgage and loans from one or more public agencies, together with equity generated from the “sale” or syndication of federal low-income housing tax credits (LIHTCs) to provide permanent financing for developments. The new state and local housing initiatives will contribute funds for loans that developers can use in this leveraging process. LIHTCs are an equally essential component in this equation. Congress created the LIHTC program under the 1986 Tax Reform Act to promote private investment in multifamily housing. The credit is calculated based on a percentage of eligible development costs and taken by investors over a 10-year period. LIHTCs come in two forms: a 9-percent credit allocated competitively by each state and a 4-percent credit awarded with the issuance of private activity bonds. Since its inception, the National Multifamily Housing Council reports LIHTCs have helped finance nearly three million apartment units.

California’s housing initiatives could suffer a serious, if not devastating, impact from purported tax reform legislation being considered by Congress. In mid-November, the U.S. House of Representatives approved H.R. 1, the Tax Cuts and Jobs Act. One change in tax law made by this bill—eliminating the tax exemption for private activity bonds—would have an adverse impact on affordable housing production. Without this exemption, affordable housing developers would lose access to 4-percent LIHTCs. According to California State Treasurer John Chiang’s office, California used $6 billion in private activity bonds (PABs) in 2016 to finance affordable housing projects that resulted in an allocation of $2.2 billion in LIHTCs. Collectively, this helped build or preserve 20,600 housing units.

A month later, the Senate by a two-vote margin passed its version of a tax reform bill. Unlike the House, the Senate preserved the status quo for PABs. However, both tax bills reduce the corporate tax rate from 35 percent to 20 percent. Lower tax rates mean corporations have less appetite for tax credits, including LIHTCs, which translates to lower credit prices and reduced equity for projects. The Senate also adopted a Base Erosion and Anti-Abuse Tax (BEAT).... As one website explains, “BEAT targets...large companies with foreign operations...[that]...reduce their tax bills through cross-border payments they can deduct in the U.S. According to CHPC, BEAT “means that banks with significant foreign operations such as Union Bank, could lose their interest in purchasing housing credits, disqualifying banks and other investors that account for 10 to 25 percent of the capital invested in the housing credit market.”

The tax reform bill is touted as a jobs creation measure; however, in the context of rental housing construction, the bill accomplishes precisely the opposite. Novogradac & Company, an accounting firm, reports more than 1.1 million jobs would be lost under the House tax bill over the next 10 years, including 296,180 jobs in California. Equally important, when people can afford housing and have a stable living environment, it allows them to seek work and retain those jobs.

For families and individuals struggling to find or keep a safe, clean, affordable place to live, LIHTCs, PABs, and BEAT have no meaning. Depending on how Congress acts on tax reform, these obscure acronyms could suddenly have a very real and lasting impact as these people try to keep a roof over themselves.

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